

4-1-1970

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## Recommended Citation

Walter D. Navin Jr., *Waiver of Defense Clauses in Consumer Contracts*, 48 N.C. L. REV. 505 (1970).Available at: <http://scholarship.law.unc.edu/nclr/vol48/iss3/4>

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# WAIVER OF DEFENSE CLAUSES IN CONSUMER CONTRACTS

WALTER D. NAVIN, JR.\*

## INTRODUCTION

In sum, adopting a consumer perspective involves investigating a transaction, a principle, or a concept through observation of the specific human targets it touches and the time and the occasions when it affects them. One asks concretely, whom does it concern and when, who needs it and why, who uses it and how, who gains from it and wherein? We propose now to look at the meaning of justice in this perspective of consumers.

—Edmund Cahn, *Confronting Injustice*

One can imagine the indignation with which Mr. Cahn would have reacted to *Baldino v. ABC Appliance Service*.<sup>1</sup> In this case Mr. Baldino attempted to restrain a bank from reporting him as a bad credit risk because he had refused to pay a balance due on a television set that did not work and that the bank had repossessed and sold at auction. Baldino lost, because the legal paper he had signed in financing the purchase of the television set from the dealer happened to contain a clause providing that it might be assigned and that the assignee should have all the rights, powers and remedies of the assignor but should be subject to none of his obligations. At the time of the decision it was well settled in Pennsylvania that Baldino was estopped from asserting, as against the assignee, that the set was defective.

The decision could not be attacked on traditional legal grounds; prior authority in Pennsylvania clearly supports the result.<sup>2</sup> Had a negotiable promissory note been the basis of controversy, the result would have been the same with the added force of statutory imprimatur.<sup>3</sup>

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\* Professor of Law, University of North Carolina. My Research Assistant, Norman E. Smith, is acknowledged for the many contributions made in the preparation of this article, which was written in cooperation with the North Carolina Law Center.

<sup>1</sup> 83 Pa. D. & C. 305 (Phila. County Ct. 1952).

<sup>2</sup> *Humphrey v. Tozier*, 164 Pa. 410, 26 A. 542 (1893); *Lester Bros. v. Shoop*, 2 Pa. D. & C. 762 (Crawford County Ct. 1922); *Cox v. Shenk*, 28 Pa. Dist. 160 (Perry County Ct. 1915).

<sup>3</sup> See PA. STAT. tit. 12A, § 3-304 (1954); *First Nat'l Bank v. Hartman Co.*, 147 Pa. Super. 396, 24 A.2d 582 (1942).

In a fact situation such as *Baldino*, there are many problems other than, and probably more important than, cutting off defenses. Did the contract that Baldino signed disclose adequately the nature of the transaction, including the amount of interest he was to be charged? Was the sale upon repossession a proper one, conducted according to reasonable commercial standards? Should the financing agency be regulated by the state since it is dealing with commercial paper in an area in which the generally naive public can be easily injured? Was the television set advertised falsely, and if so, what remedies did Baldino have? The list could be expanded to some length.<sup>4</sup>

In one sense, at least, *Baldino* does not illustrate the full range of injustices possible. The television set did not work but, unless selling one that does not work and refusing to replace or repair it is a species of fraud, there are more terrifying examples of nefarious schemes practiced by unscrupulous sellers on innocent buyers. Home repair salesmen, for instance, seem to have an inexhaustible supply of aluminum siding that, when installed, falls off the consumer's home shortly after the salesman has disappeared.<sup>5</sup> Seldom will a lawsuit arise in which the buyer's remedies against the seller are of any intrinsic value. The seller is bankrupt or not within the jurisdiction—or in jail.

Having considered a typical fact situation in *Baldino*, let us turn to its legal and commercial setting. Faced with the effect of mass production and distribution techniques in the movement of consumer goods in the early years of this century, the law fell back on a venerable classification system to handle the need for buyers of such items to be able to spread their payments over a period of time. The buyer could secure a loan—borrow directly from a lending institution and pay cash to the seller—or he could enter into an installment-sale contract with the seller whereby the purchase price was payable in installments over a period of time. The legal treatment accorded these two methods of financing was substantially different.

For one thing, in the case of a direct installment purchase, a charge for extension of time was not considered interest but simply the extraction of consideration for the privilege of paying over a period of months or

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<sup>4</sup> See Comment, *Translating Sympathy for Deceived Consumers into Effective Programs for Protection*, 114 U. PA. L. REV. 395 (1966).

<sup>5</sup> *New Jersey Mortgage & Inv. Corp. v. Calvetti*, 68 N.J. Super. 18, 171 A.2d 321 (App. Div. 1961); *Sterling Commercial Corp. v. White*, 5 U.C.C. Rep. Serv. 516 (N.Y. Sup. Ct. 1968). See also *Matthews v. Aluminum Acceptance Corp.*, 1 Mich. App. 570, 137 N.W.2d 280 (1965).

years. The sum included a wide variety of additional charges, the most important of which was an amount equal to the discount demanded of the seller by the financing agency. This financing charge usually was relatively sizeable in amount because the usury statutes did not apply. In terms of percentage of the sale price on a per annum basis, a range from twenty to thirty per cent would be a conservative estimate of the amount of the finance company's discount. Because the merchant ran the credit risk, he could charge for it. A buyer of goods did not have to buy them; he could wait until he had the cash if he so desired. On the other hand, wage earners who had to borrow money were usually in desperate straits and money lenders could take advantage of them. Thus, early legislation regulated the money lenders but ignored the time sale.<sup>6</sup>

It came to be that in making the ordinary time purchase, a customer signed a negotiable promissory note (naming the dealer payee) for the total amount due on the contract of purchase. In addition, he executed a document that in one manner or another was intended to give the seller a security interest in the goods sold. Sometimes he executed still another document purporting to be a contract covering all the terms of the transaction.

Of course, the ordinary seller did not have the capital with which to finance the time purchases of all his customers. He turned to financing institutions—first to the newly-formed financing companies and later to his local bank. To a lesser extent, other institutions, such as credit unions, were also utilized.<sup>7</sup> No financing agency wanted to buy a lawsuit, and it became apparent that buyers would have plenty of actionable grounds against their sellers. But these defenses could be cut off by the simple expedient of formality. If the buyer's obligations were expressed in a negotiable promissory note and if it were negotiated to the financing agency according to the standards of the negotiable instruments law, then the defenses were cut off because the financing agency became that most favored person, a holder in due course.<sup>8</sup>

One of the requirements of form, however, tended to require a relatively simple document. The promise had to be unconditional, and if

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<sup>6</sup> See generally B. CURRAN, TRENDS IN CONSUMER CREDIT LEGISLATION 5-14 (1965); Gilmore, *The Commercial Doctrine of Good Faith Purchase*, 63 YALE L.J. 1057, 1093-1102 (1954) [hereinafter cited as Gilmore].

<sup>7</sup> See B. CURRAN, *supra* note 6, at 9.

<sup>8</sup> See UNIFORM COMMERCIAL CODE §§ 3-302 to -306 wherein the holder in due course concept is enunciated.

the document utilized concerned itself with such matters as title retention for security purposes, there was the chance that a court would hold the instrument non-negotiable.<sup>9</sup> Responding to such decisions, and for other reasons, financing agencies developed what came to be known as the retail installment sales contract, a device that attempted to overcome many of the problems facing them. It usually contained the terms of the sale, mirrored in a form suitable for a security device in a given jurisdiction (for example, chattel mortgage, conditional sale contract or trust receipts agreement). At the bottom of the security device, a negotiable promissory note was appended by perforations. Both note and contract were signed by the buyer and transferred by the seller to the financing agency, the note by indorsement and the contract by assignment.

In order to make the circle of protection complete for the financier, the contract contained a clause by which the buyer promised not to assert against any transferee of the contract any claim or defense that he might have against the transferor-seller.<sup>10</sup> When the financing agency found it necessary to proceed against the buyer-obligor, not on the promissory note, but on the accompanying contract, the question of the validity of the waiver clause came into controversy.<sup>11</sup>

In one sense, the legal questions involved in waiver-of-defense clauses were worked out in a superficially simple manner. Either the waiver clause was invalid as a matter of public policy and therefore unenforceable,<sup>12</sup> or it was not. In *Baldino*, the court held that the clause was not against public policy and that therefore it should be enforced.<sup>13</sup> This dichotomy indicates the posture of the cases before the Uniform Commercial Code became a legal reality; yet even in cases that pre-date the Code, the decisions were not clear-cut—often the clause was invalid but the obligor was estopped to assert it, or the clause was held invalid

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<sup>9</sup> See *id.* § 3-104(1) (b); *President & Directors of Manhattan Co. v. Morgan*, 242 N.Y. 38, 150 N.E. 594 (1926); *Selected Inv. Corp. v. Lester*, 327 P.2d 668 (Okla. 1958). See also *State Nat'l Bank v. Cantrell*, 47 N.M. 389, 143 P.2d 592 (1943).

<sup>10</sup> A recent case illustrative of the practice is *General Elec. Credit Corp. v. Tidenberg*, 78 N.M. 59, 428 P.2d 33 (1967).

<sup>11</sup> *Id.*

<sup>12</sup> See *Equipment Acceptance Corp. v. Arwood Can Mfg. Co.*, 117 F.2d 442 (6th Cir. 1941); *American Nat'l Bank v. A. G. Sommerville, Inc.*, 191 Cal. 364, 216 P. 376 (1923). *Contra*, *United States ex rel. Adm'r of Fed. Housing Admin. v. Troy-Parisian, Inc.*, 115 F.2d 224 (9th Cir. 1940); *A. J. Colson & Sons v. Ellis*, 40 Ga. App. 768, 151 S.E. 654 (1930); *General Elec. Credit Corp. v. Tidenberg*, 78 N.M. 59, 428 P.2d 33 (1967); *Anglo-California Trust Co. v. Hall*, 61 Utah 223, 211 P. 991 (1922).

<sup>13</sup> 83 Pa. D. & C. at 306-07.

if the defense was fraud but not if it was breach of warranty.<sup>14</sup> The coming of the Code, now enacted in all United States jurisdictions except Louisiana, makes a waiver-of-defense clause a valid exercise of the right to contract unless there is a contrary local statute or decision applicable to the sale of consumer goods.<sup>15</sup> Out of the interstices arising from this legislative grant of validity, the exception to it, and historical precedents have come a sizeable number—indeed, a surprisingly large number—of cases. Most of the literature in the field concerns the broader question of consumer protection in general.<sup>16</sup> Professor Littlefield has reviewed many of the cases concerned with the concept of negotiability and holder in due course.<sup>17</sup> In an earlier day, Professor Beutel examined negotiability by contract.<sup>18</sup> It is the purpose of this article to review the decisions and statutes concerning waiver-of-defense clauses and to attempt to illuminate those areas in which, despite an obviously expanding trend toward protecting consumers such as Mr. Baldino, serious problems continue to exist.

#### THE GOOD FAITH ASSIGNEE

Negotiability as a concept whereby defenses are cut off has been ingrained in the law for a long time and, consequently, a complex constellation of rules has developed concerning it and, more particularly, the holder in due course. To be a holder in due course, a holder must take the negotiable instrument for value, in good faith, without notice of any claims or defenses, and before maturity. Courts have applied similar requirements to an assignee claiming the protection of a waiver clause. We here examine some of the consequences of these requirements.

Over the two centuries or so in which the rules with respect to negotiability developed, factual situations were presented in such variety that, based on a merchant-oriented view of the times, the rules became fairly clear in exposition and were utilized extensively in a predictive sense.

<sup>14</sup> Compare *Anglo-California Trust Co. v. Hall*, 61 Utah 223, 211 P. 991 (1922) with *American Nat'l Bank v. A. G. Sommerville, Inc.*, 191 Cal. 364, 216 P. 376 (1923).

<sup>15</sup> UNIFORM COMMERCIAL CODE § 9-206.

<sup>16</sup> See, e.g., Skilton & Helstad, *Protection of the Installment Buyer of Goods under the Uniform Commercial Code*, 65 MICH. L. REV. 1465 (1967); Comment, *Translating Sympathy for Deceived Consumers into Effective Programs for Protection*, 114 U. PA. L. REV. 395 (1966).

<sup>17</sup> Littlefield, *Good Faith Purchase of Consumer Paper: The Failure of the Subjective Test*, 39 S. CAL. L. REV. 48 (1966) [hereinafter cited as Littlefield].

<sup>18</sup> Beutel, *Negotiability by Contract, A Problem in Statutory Interpretation*, 28 ILL. L. REV. 205 (1933).

A lawyer for a bank could tell his client that mere knowledge of the executory nature of the contract in which the negotiable promissory note originated did not destroy the bank's status as holder in due course. The statute said so.<sup>19</sup> This knowledge neither gave the bank notice nor meant that it took in bad faith.

The courts stumbled a bit in ironing out the good-faith concept, but most concluded eventually that the taker had to be dishonest in fact before his status as a good-faith holder was destroyed.<sup>20</sup> Subjective dishonesty on the part of the taker, not objective suspicions, became the test. Negligence in the acquisition of negotiable paper, as by purchase from a shady character,<sup>21</sup> did not destroy one's status as a holder in due course. Yet, it became apparent that while subjective dishonesty might be the generality, there were plenty of particular facts that simply went against the grain of human experience when viewed in terms of subjectivity of the purchaser. No one could purchase paper overdue on its face and then plead subjective honesty; nor could one assert subjective innocence after purchase at a judicial sale; and a purchaser could not knowingly take from a trustee in satisfaction of the trustee's personal debt and then plead that subjectively he had no knowledge of the beneficiary's interest.<sup>22</sup> But instances of objective circumstances that destroy holder-in-due-course status are not often presented to the courts.

As one might expect, most of the rules have been utilized in waiver-of-defense situations, the courts naturally turning to the negotiability rules when confronted with waiver problems. But old rules about holders in due course give modern courts difficulty in reaching consumer-oriented decisions that are just and equitable. Sometimes judges simply fail to apply the old rule to the new fact and blink nary a judicial eye.

In *First & Lumbermen's National Bank v. Bucholz*,<sup>23</sup> a 1945 Minnesota decision, the assignee-holder of a conditional sales contract, to which had been attached by perforation a negotiable promissory note, brought suit against the original obligor, a purchaser of a faulty coal burner that destroyed a large stock of flowers in his greenhouse. The contract contained a waiver clause. Despite the fact that the assignee-holder had both the mantle of a holder in due course by virtue of the negotiable instrument and the availability of the waiver clause, the

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<sup>19</sup> As does UNIFORM COMMERCIAL CODE § 3-304(4) (b).

<sup>20</sup> Littfield, *supra*, note 17, at 50-59.

<sup>21</sup> Setzer v. Deal, 135 N.C. 428, 47 S.E. 466 (1904).

<sup>22</sup> UNIFORM COMMERCIAL CODE §§ 3-304(3) (a), 3-304(2), 3-302.

<sup>23</sup> 220 Minn. 97, 18 N.W.2d 771 (1945).

court construed the negotiable promissory note and the accompanying conditional sales contract as one agreement and made the promise to pay in the note conditional upon the performance of the promised consideration in the contract. The court was thus able to distinguish the old rule that mere knowledge of the executory nature of a contract did not destroy the status of a holder in due course with respect to the negotiable promissory note originating in the same transaction.<sup>24</sup>

Sometimes, of course, application of the old rule is helpful. In *Shepard v. Commercial Credit Corp.*,<sup>25</sup> a 1962 decision, the Vermont Supreme Court could say with ease that since the retail installment sales contract, which contained a waiver clause, bore a material alteration apparent on its face (another one of those objective facts that destroyed good-faith status regardless of subjective intent),<sup>26</sup> the assignee could not be a holder in due course.

It is clearly the majority rule that one who takes a negotiable promissory note together with a financing agreement takes as a holder in due course.<sup>27</sup> The court in *Bucholz*, however, reached an opposite conclusion<sup>28</sup> by applying the so-called single-contract theory whereby the conditions in the sales contract destroyed the negotiability of the accompanying promissory note. The development of this theory and the distinction between an action to recover the goods—in which case defenses were available—and the action on the note—in which case they were not (the rule found in early drafts of the UCC)<sup>29</sup>—were mid-twentieth-century attempts to correct the imbalance in favor of the holder in due course resulting from an earlier century's mercantile bias. They failed to win acceptance.

Perhaps the major tool in the twentieth-century arsenal of rules for the protection of the consumer is the expanding view that the financing agency taking paper may be so inextricably interwoven in the entire transaction as to be a party to it, with knowledge of all its facets. This view precludes the financier from being a holder in due course of a negotiable promissory note, and thus means it is subject to the defenses of

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<sup>24</sup> *Id.* at 102-03, 18 N.W.2d at 774.

<sup>25</sup> 123 Vt. 106, 183 A.2d 525 (1962).

<sup>26</sup> UNIFORM COMMERCIAL CODE § 3-304(1)(a).

<sup>27</sup> See Annot., 44 A.L.R.2d 8, 58-68 (1955).

<sup>28</sup> 220 Minn. at 102-03, 18 N.W.2d at 774. See *State Nat'l. Bank v. Cantrell*, 47 N.M. 389, 143 P.2d 592 (1943), for a direct holding against a holder in due course based on single-contract theory, when the holder was also assignee of the conditional sales contract.

<sup>29</sup> UNIFORM COMMERCIAL CODE § 9-206(1) (1952 version).



the obligor. Based on a 1940 Arkansas decision,<sup>30</sup> polished in Florida<sup>31</sup> and California,<sup>32</sup> the theory finds its most recent and comprehensive exposition in a widely cited 1967 New Jersey case, *Unico v. Owen*.<sup>33</sup>

In *Unico*, Mrs. Owen decided to take advantage of an advertisement that promised to give her a stereo record player if she would purchase 140 albums of fine music. The free phonograph and the albums turned out to cost more than \$800, most of which was financed by a retail installment sales contract and the buyer's promissory note, both of which were immediately transferred by the seller to the plaintiff, Unico. Mrs. Owen received the record player and twelve albums before the seller became bankrupt. She reasoned, "No music, no money," and the financing agency sued. The opinion contains a statement of the developing rule:

The courts have recognized that the basic problem in consumer goods sales . . . is that of balancing the interest of the commercial community in unrestricted negotiability of commercial paper against the interest of installment buyers of such goods in the preservation of their normal remedy of withholding payment when, as in this case, the seller fails to deliver as agreed. . . . Many courts have solved the problem by denying to the holder of paper the status of holder in due course where the financier maintains a close relationship with the dealer whose paper he buys; where the financier is closely connected with the dealer's business operations or with the particular credit transaction; or where the financier furnishes the form of sale contract and note for use by the dealer, the buyer signs the note and contract concurrently, and the dealer endorses the note and assigns the contract immediately thereafter or within the period prescribed by the financier. Other courts have said that when the financier supplies or prescribes or approves the form of the sale contract, or conditional sale agreement, or chattel mortgage as well as the installment payment note (particularly if it has the financier's name printed on the face or in the endorsement) and all the documents are executed by the buyer at one time and the contract assigned and note endorsed to the financier and delivered to the financier together . . . the holder takes subject to the rights and obligations of the seller. The transaction is looked upon as a species of tripartite proceeding, and the tenor of the cases is that the financier should not be permitted to isolate itself behind the fictional fence of

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<sup>30</sup> Commercial Credit Co. v. Childs, 199 Ark. 1073, 137 S.W.2d 260 (1940).

<sup>31</sup> Mutual Fin. Co. v. Martin, 63 So. 2d 649 (Fla. 1953).

<sup>32</sup> Commercial Credit Corp. v. Orange County Mach. Works, 34 Cal. 2d 766, 214 P.2d 819 (1950).

<sup>33</sup> 50 N.J. 101, 232 A.2d 405 (1967).

the Negotiable Instruments law and thereby achieve an unfair advantage over the buyer.<sup>34</sup>

The court held that Unico was not a holder in due course. It emphasized the executory nature of the original transaction and the close and intimate supervision of the form of the sale by the financier. But the effect of a waiver-of-defense clause in the conditional sales contract also had to be considered. Even if Unico were not a holder in due course of the note, had not Mrs. Owen contracted away her right to assert any defense? The court answered by holding the waiver clause void as against public policy.<sup>35</sup> Several courts have treated waiver clauses in like manner;<sup>36</sup> some have expressly recognized their validity;<sup>37</sup> and, of course, many have not spoken on the subject.<sup>38</sup>

As applied to the question whether the transferee is a holder in due course of commercial paper, the rule expressed in *Unico* can be described in terms of an objective test<sup>39</sup> rather than one of subjective good faith. The rule has also been described in agency terms, the finance company being classified as a principal and thus a party to the transaction.<sup>40</sup> If put in the traditional language of good faith, it is apparent that the honesty in fact of the finance company is not relevant. Again, through the legal lens of good faith, a fact pattern can be seen emerging in which human experience refuses to accept the honesty of the finance company as the test for cutting off the defenses of the consumer. Naturally, this rule has been applied in waiver cases, and, also quite naturally, the cases evidence continuing confusion as to its scope and application.

One tactical value of the doctrine of objectivity is that it permits a showing to the jury of the economic-legal fact situation that exists in most consumer installment transactions. A motion for summary judgment by a financing agency that possesses all other attributes of a holder in due course, including the absence of actual knowledge of the dealer's activities, may be denied since a question of fact still exists: did plaintiff take in good faith as measured by an objective standard? More and more cases

<sup>34</sup> *Id.* at 112-13, 232 A.2d at 411-12.

<sup>35</sup> *Id.* at 125-26, 232 A.2d at 418.

<sup>36</sup> Cases cited as authority in note 12 *supra*.

<sup>37</sup> Cases cited *contra* in note 12 *supra*.

<sup>38</sup> See p. 531 *infra* for a discussion of legislative action in this area.

<sup>39</sup> Littlefield, *supra* note 17, at 48.

<sup>40</sup> *Commercial Credit Corp. v. Orange County Mach. Works*, 34 Cal. 2d 766, 214 P.2d 819 (1950) (agency); *Mutual Fin. Co. v. Martin*, 63 So. 2d 649 (Fla. 1953) (the finance company is really a party to the transaction).

have resulted in the consumer withstanding a motion for summary judgment,<sup>41</sup> and, as Professor Gilmore observes, once the consumer can get to the jury the results are highly predictable.<sup>42</sup> This outcome was not the usual result under the traditional view of good faith, and there have been recent decisions that have sustained a financing agency's motion for summary judgment under similar circumstances.<sup>43</sup>

Professor Britton has observed that a concept such as good faith will receive its meaning primarily in the trial court through rulings for instructions, motions for directed verdicts, motions for new trials, motions for summary judgments, motions to dismiss, and the like.<sup>44</sup> A New York trial judge's treatment of the good-faith problem in *Star Credit Corp. v. Molina*<sup>45</sup> is worth reviewing. The controversy concerned a common food-freezer marketing scheme; when the buyers, the Molinas, did not get what they had bargained for, they stopped making payments, and the finance company, Star Credit Corporation, brought suit. The retail installment sales contract, which mirrored the transaction and was the basis of Star's claim, contained a waiver clause. Since a New York statute validates waivers if the assignee gives notice and since notice had been given but had evoked no response from the obligors, the finance company argued that the Molinas could not assert in any manner any defenses of fraud in the inducement or failure of consideration. The company alleged that it had been honest in fact, was a separate entity, had not participated in the original sale, and was thus an assignee in good faith. The trial judge thought that the argument might have merit in cases of businessmen dealing with businessmen since the Uniform Commercial

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<sup>41</sup> *Noblett v. General Elec. Credit Corp.*, 400 F.2d 442 (10th Cir. 1968); *McCoy v. Mosley Mach. Co.*, 33 F.R.D. 287 (E.D. Ky. 1963); *Sterling Commercial Corp. v. White*, 5 U.C.C. Rep. Serv. 516 (N.Y. Sup. Ct. 1968); *General Elec. Credit Corp. v. Beyerlein*, 55 Misc. 2d 724, 286 N.Y.S.2d 351 (Sup. Ct. 1967), *aff'd mem.* 30 App. Div. 2d 762, 292 N.Y.S.2d 32 (1968); *Fairfield Lease Corp. v. Colonial Aluminum Sales, Inc.*, 3 U.C.C. Rep. Serv. 858 (N.Y. Sup. Ct. 1966); *Titone v. General Elec. Credit Corp.*, 201 Misc. 1041, 108 N.Y.S.2d 909 (Sup. Ct. 1951); *Central Budget Corp. v. Sanchez*, 53 Misc. 2d 620, 279 N.Y.S.2d 391 (N.Y. City Civ. Ct. 1967); *Public Nat'l. Bank & Trust Co. v. Fernandez*, 121 N.Y.S.2d 721 (N.Y. City Mun. Ct. 1952).

<sup>42</sup> Gilmore, *supra* note 6, at 1098.

<sup>43</sup> *Beam v. John Deere Co.*, 240 Ark. 98, 398 S.W.2d 218 (1966); *General Elec. Credit Corp. v. Tidenberg*, 78 N.M. 59, 428 P.2d 33 (1967); *National State Bank v. Dzurita*, 2 U.C.C. Rep. Serv. 728 (N.Y. Sup. Ct. 1965); *B.W. Acceptance Corp. v. Richmond*, 46 Misc. 2d 447, 259 N.Y.S.2d 965 (Sup. Ct. 1965); *National City Bank v. LaPorta*, 109 N.Y.S.2d 143 (Sup. Ct. 1951).

<sup>44</sup> W. BRITTON, *BILLS AND NOTES* § 101, at 247 (2d ed. 1961).

<sup>45</sup> 6 U.C.C. REP. SERV. 70 (N.Y. County Civ. Ct. 1969).

Code is a charter for the ordering of economic life, and it is not unreasonable to expect a businessman to inform himself of all the rules coiled within the Code and to protect himself against their springing out.<sup>46</sup> The judge felt that even though the Molinas were literate, they were hardly sophisticated enough to understand the cut-off provision; he also found significant that there was no parity of bargaining power.

For these reasons, we hold that "good faith" as used in [UCC] 9-206 means more than "honesty in fact" when, in circumstances such as those presented here, an assignee seeks to bar a consumer from asserting against the assignee claims and defenses to the underlying obligation.<sup>47</sup>

Because the contract bore on its reverse side a printed assignment form, and was in fact assigned within twenty-four hours after its execution at a substantial discount, and because the dealer's contract number became the financing agency's contract number, the trial judge was persuaded that the seller entered into such transactions not primarily to sell freezers but to generate commercial paper and that it did so with the full knowledge and approval of the financing agency. Thus, he held that the plaintiff was not an assignee in good faith and took subject to the defenses. A judgment dismissing the complaint was entered.<sup>48</sup>

Another New York trial judge had the opportunity to rule on a motion for summary judgment in a controversy involving a coffee vending machine that was not within the scope of the state's legislation affording protective measures for purchasers of consumer goods. He held that since the relevant facts concerning the financing company's status as an assignee in good faith were exclusively within the knowledge of the moving party—the finance company—the matter was not one to be resolved on a motion for summary judgment.<sup>49</sup> On the other hand, the opposite result obtained in *National State Bank v. Dzurita*.<sup>50</sup> In granting a finance company's motion for summary judgment, the judge trotted out the old verbalizations of the rule of subjectivity—"the simple test of honesty and good faith."<sup>51</sup> The waiver clause was held valid and given

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<sup>46</sup> *Id.* at 73.

<sup>47</sup> *Id.*

<sup>48</sup> *Id.* at 75.

<sup>49</sup> *Fairfield Lease Corp. v. Colonial Aluminum Sales, Inc.*, 3 U.C.C. Rep. Serv. 858 (N.Y. Sup. Ct. 1966).

<sup>50</sup> 2 U.C.C. Rep. Serv. 728 (N.Y. Sup. Ct. 1965).

<sup>51</sup> *Id.* at 730.

effect because without it banks would find it impossible to finance installment purchases.<sup>52</sup>

The Uniform Commercial Code in section 9-206 validates waiver clauses, subject to contrary statutes or decisions respecting consumer goods.<sup>53</sup> However, the section is applicable only in cases in which the assignee has taken "in good faith and without notice of a claim or defense, except as to defenses of a type which may be asserted against a holder in due course of a negotiable instrument . . . ."<sup>54</sup> Considerable litigation has already involved interpretations of section 9-206, and the question of good faith continues to be one for case-by-case resolution. For example, the rule enunciated in *Unico* emphasizes in one manner or another the relationship between the financier and the dealer. Assuming no contrary statute or decision with respect to consumer goods, how close must this relationship be before the financing agency loses the mantle of section 9-206 protection? How far can it go in policing the transaction and still not run afoul of the good faith rule? In *First National Bank v. Husted*,<sup>55</sup> a decision from Illinois, the fact that the printed form of the contract contained the statement that the contract was to be assigned to plaintiff bank did not destroy the bank's good-faith status. Yet in many other cases,<sup>56</sup> the presence on the printed form of the financier's name, as assignee or transferee, has at least been one factor justifying application of the "inextricably-interwoven" test and destruction of good-faith status. In some cases, such a printed form alone has been enough to defeat the assignee's assertion of good faith.<sup>57</sup> Two recent Utah cases illustrate the elusive nature of the problem.

In *Lundstrom v. Radio Corp. of America*,<sup>58</sup> the court held that the financing agency had acted in good faith when it had telephoned the obligors and warned them that the dealer's referral scheme was not a part of the contract assigned to the financier, required the dealer to record on a mechanical device the buyer's statement to that effect, and required the buyer's signed acknowledgment to that effect. The form contract as printed did contain the financing agency's name. (For the uninitiated, a referral scheme exists when the seller promises the buyer that he will

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<sup>52</sup> *Id.*

<sup>53</sup> UNIFORM COMMERCIAL CODE § 9-206 (1962 version).

<sup>54</sup> *Id.*

<sup>55</sup> 57 Ill. App. 2d 227, 205 N.E.2d 780 (1965).

<sup>56</sup> See Annot., 44 A.L.R.2d 8, 58-68 (1955).

<sup>57</sup> *E.g.*, *Palmer v. Associates Discount Corp.*, 124 F.2d 225 (D.C. Cir. 1941).

<sup>58</sup> 17 Utah 2d 114, 405 P.2d 339 (1965).

receive a cash payment for each prospective customer's name furnished the seller by the buyer. Such payments appear to be seldom, if ever, actually made.) The obligor in *Lundstrom*, attempting to avoid a waiver clause, argued that all this activity on the part of the finance company must have indicated its awareness and knowledge of the dealer's shenanigans, but the finance company obtained a jury verdict, and the Utah Supreme Court affirmed.

The following year, in *Schow v. Guardtone, Inc.*,<sup>59</sup> the same court had to contend with another allegedly fraudulent dealer, this one in the business of installing fire alarm systems in homes. The same scheme—a referral offer—permeated the original transaction. The jury found for the obligor but the trial judge gave judgment notwithstanding the verdict to the finance company, an assignee of the retail installment sales contract that contained a waiver clause. In reversing, the court pointed out that the printed form of assignment contained the name of the financing agency and that the contract was bought with recourse against the dealer. It held that one could reasonably believe that the assignee had something to do with the initial transaction and, therefore, was not an assignee in good faith.

Rules of appellate review may explain the difference in outcome of the two cases; jury verdicts are not lightly to be disturbed. Yet to allow a jury to conclude, at least partially on the basis of the printed form of assignment, that the finance company was not in good faith is a dramatic illustration of an application of the objective theory of good faith.

Consider also the course of judicial decisions in recent years in Kentucky. In 1959, the Kentucky Court of Appeals approved a waiver-of-defense clause as not offensive to public policy.<sup>60</sup> In that opinion, however, the court applied a version of the "inextricably-interwoven" doctrine to estop a finance company and a dealer from asserting a prior security interest against another secured party. This case has been cited as approving waiver clauses, but the application of the "interwoven" doctrine has been generally ignored. In 1965, for example, a buyer of a farm tractor that did not work was required to pay the financing agency that had taken his conditional sale contract.<sup>61</sup> Summary judgment was affirmed,

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<sup>59</sup> 18 Utah 2d 135, 417 P.2d 643 (1966).

<sup>60</sup> *Walter J. Hieb Sand & Gravel, Inc. v. Universal C.I.T. Credit Corp.*, 332 S.W.2d 619 (Ky. Ct. App. 1959).

<sup>61</sup> *Morgan v. John Deere Co.*, 394 S.W.2d 453 (Ky. Ct. App. 1965).

and no mention was made of the "interwoven" doctrine. The same result occurred in 1967, and again no mention was made of the relationship between the financing agency and the dealer.<sup>62</sup> In both cases there would appear to be no question that one could easily point to facts that should at least have gotten the controversies to the jury on the issue of good faith. For example, in the 1967 case, the obligor bought a tractor from a dealer who in turn sold the paper to the manufacturer of the tractor. In a case involving almost parallel facts in 1969, however, the same court upheld a trial judge who had permitted the jury to consider the evidence and render a verdict for the buyer of a Massey-Ferguson corn combine.<sup>63</sup> The court held that since the manufacturer furnished the paper forms, it could be classified as the seller.

In *Morgan v. Reasor Corp.*,<sup>64</sup> the California Supreme Court opted for the objective standard of good faith in an interesting and complex example of litigation over a mid-twentieth-century retail installment sales contract. Morgan purchased a prefabricated home for erection upon his land and paid for it by executing a promissory note and a document entitled "Lien Contract and Deed of Trust." A term of the document transferred to the financing agency title to both the house and lot as security for the purchase price. The financial aspects are intriguing: the home cost was \$11,844, but a time-price differential of \$7,554.12 was added, making the total indebtedness well over \$19,000. California had recently enacted the Unruh Act,<sup>65</sup> a comprehensive regulation of retail installment sales. Among the questions the court had to resolve was whether to invoke section 1812.7, which provides that any person who acquires a retail installment contract "with knowledge" of any noncompliance with the Act shall be barred from recovery of the time-price differential. The Act requires the contract and note to be contained in one document. When the financing company acquired them, they were separate documents. Since California law, to that time, had provided that a holder in due course had no duty to investigate suspicious circumstances in acquiring negotiable paper<sup>66</sup> (the classic subjective test), the court had to decide whether to apply that same test to the knowledge requirement of section 1812.7. To its credit, it did not. Moreover, the court consciously spelled out its realization

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<sup>62</sup> *Root v. John Deere Co.*, 413 S.W.2d 901 (Ky. Ct. App. 1967).

<sup>63</sup> *Massey-Ferguson, Inc. v. Utley*, 439 S.W.2d 57 (Ky. Ct. App. 1969).

<sup>64</sup> 69 Cal. 2d 881, 447 P.2d 638, 73 Cal. Rptr. 398 (1968).

<sup>65</sup> CAL. CIV. CODE §§ 1801-1812.10 (West Supp. 1969).

<sup>66</sup> *Popp v. Exchange Bank*, 189 Cal. 296, 301-02, 208 P. 113, 115-16 (1922).

that it was adopting a test of "constructive knowledge"—in short, an objective test:

Midwest [the acquiring finance company-predecessor in interest to Reasor Corporation] knew of facts which would have put a reasonable man on inquiry as to whether the note and contract had originally been contained in a single document; a cursory inquiry would have revealed the violation [of the statute]. These factors constitute sufficient 'knowledge' under section 1812.7.<sup>67</sup>

#### ESTOPPEL AND WAIVERS

That Mother Hubbard of the law, estoppel, has been applied to waiver-of-defense clauses with a super gloss of history, policy, and wordage so thick and viscous as to be impregnable. It is, for example, not too difficult to find two decisions in the same jurisdiction on essentially similar facts that reach opposite results in the name of estoppel.<sup>68</sup> Some courts upholding waivers have said they were applying a form of estoppel by contract; the reasoning is that once the obligor has promised not to assert a defense, he cannot later change his mind after action in reliance on his promise.<sup>69</sup> Most courts, however, apply a theory that is more properly labeled estoppel by conduct of the obligor.

The questions presented in estoppel cases that concern us are more specific than such labeling. Can the concept of estoppel overcome statutes that otherwise aid the consumer-obligor?<sup>70</sup> Does an acknowledgment of delivery or the execution of a completion certificate work an estoppel that permits an assignee to recover when otherwise he could not?<sup>71</sup> Is

<sup>67</sup> 69 Cal. 2d at 889, 447 P.2d at 643, 73 Cal. Rptr. at 403.

<sup>68</sup> Compare *Universal Credit Co. v. National Radio Mfg. Co.*, 174 Okla. 178, 49 P.2d 743 (1935) with *Universal Credit Co. v. Cushing Motor Co.*, 183 Okla. 63, 79 P.2d 1014 (1938); *Malas v. Lounsbury*, 193 Wis. 531, 214 N.W. 332 (1927) with *Thorp Fin. Corp. v. Le Mire*, 264 Wis. 220, 58 N.W.2d 641 (1953); *Humphrey v. Tozier*, 154 Pa. 410, 26 A. 542 (1893) with *Standard Furnace Co. v. Roth*, 102 Pa. Super. 341, 156 A. 600 (1931).

<sup>69</sup> RESTATEMENT OF CONTRACTS § 90 (1932); Beutel, *Negotiability by Contract: A Problem of Statutory Interpretation*, 28 ILL. L. REV. 205, 219 (1933). See *Lewis v. Dodson*, 151 Kan. 632, 100 P.2d 640 (1940).

<sup>70</sup> No: *American Nat'l Bank v. A. G. Sommerville, Inc.*, 191 Cal. 364, 216 P. 376 (1923). Yes: *Young v. John Deere Plow Co.*, 102 Ga. App. 132, 115 S.E.2d 770 (1960).

<sup>71</sup> Yes: *Chase Manhattan Bank v. McLeish*, 55 Misc. 2d 1009, 286 N.Y.S.2d 727 (Sup. Ct.), *rev'd*, 30 App. Div. 2d 877, 293 N.Y.S.2d 713 (1968); *National City Bank v. Prospect Syndicate, Inc.*, 170 Misc. 611, 10 N.Y.S.2d 759 (N.Y. City Mun. Ct. 1939); *Thorp Fin. Corp. v. Le Mire*, 264 Wis. 220, 58 N.W.2d 641 (1953). No: *Malas v. Lounsbury*, 193 Wis. 531, 214 N.W. 332 (1927). See DEL. CODE ANN. tit. 6, § 4312 (Supp. 1968).



there any conduct on the part of the the obligor that will prevent him from asserting a defense even though the policy of the jurisdiction is to permit consumers to raise defenses against assignees?<sup>72</sup>

The facts of two recent New York cases are illustrative of some of these problem areas. As a basis for consideration of these facts, it should be remembered that New York has enacted a statute that validates waivers of defenses in the ordinary consumer transaction if the assignee gives notice of the assignment to the buyer and if the buyer does not respond to the notice within ten days.<sup>73</sup>

In *Nassau Discount Corp. v. Allen*,<sup>74</sup> a salesman convinced Mrs. Allen that a local school board required her child to have a particular encyclopedia. She signed a conditional sale contract containing a waiver clause, and the contract was in turn assigned to the plaintiff financing corporation. No books were delivered. However, the financing corporation sent the notice required by statute along with that ubiquitous payments booklet. Instead of responding, and informing the financing corporation of her defense, as the statute contemplated, Mrs. Allen simply sent back the payments book. Did return of the book give notice that Mrs. Allen had been defrauded? Or did it merely indicate Mrs. Allen's intent to breach the contract? The court held that proper notice was not given,<sup>75</sup> but the consumer won on other grounds.

The facts of *Chase Manhattan Bank v. McLeish*<sup>76</sup> are more complicated but illustrate the use of the so-called completion certificate. The McLeishes decided to enter into a home improvement contract; bank financing was arranged by the contractor. A contract signed July 17 revealed to them that it would be assigned to the bank, that they would be required to sign a completion certificate, and that they promised not to assert against the bank any defenses they might have against the contractor. About a week later, the bank notified the McLeishes that their application for a loan had been approved and that the proceeds of it

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<sup>72</sup> Compare the dissenting opinion with the majority opinion in *Chase Manhattan Bank v. McLeish*, 55 Misc. 2d 1009, 286 N.Y.S.2d 727 (Sup. Ct. 1968). The dissenting opinion was adopted as the basis for reversal in 30 App. Div. 2d 859, 293 N.Y.S.2d 713 (1968). Compare *Public Nat'l Bank & Trust Co. v. Fernandez*, 121 N.Y.S.2d 721 (N.Y. City Mun. Ct. 1952) with *United States Nat'l Bank v. Drabish*, 187 Pa. Super. 169, 144 A.2d 640 (1958).

<sup>73</sup> N.Y. PERS. PROP. LAW § 403 (McKinney 1962).

<sup>74</sup> 44 Misc. 2d 1007, 255 N.Y.S.2d 608 (N.Y. City Civ. Ct. 1965).

<sup>75</sup> *Id.* at —, 255 N.Y.S.2d at 611.

<sup>76</sup> 55 Misc. 2d 1009, 286 N.Y.S.2d 727 (Sup. Ct.), *rev'd mem.*, 30 App. Div. 2d 859, 293 N.Y.S.2d 713 (1968).

would be paid to the contractor when all the necessary papers, including a promissory note and a completion certificate, had been signed. Thereafter, the contract was assigned to the bank and the McLeishes signed a completion certificate and a promissory note. The completion certificate warned in large bold-face type that the buyer should not sign "until the Dealer has completed the work and/or delivered the material in accordance with the terms of [their] contract or sales agreement."<sup>77</sup> The note contained a similar warning.<sup>78</sup> By August 7, both the completion certificate and the promissory note were delivered to the bank. The bank then paid the money into the contractor's account and sent notice of the assignment to the McLeishes, who promptly responded by telling the bank that the work was far from complete.

In both *Nassau* and *McLeish*, the trial court held for the consumer. In both cases the first appellate court to consider the case reversed. A dissenting justice in *McLeish* (the majority recognized estoppel by completion certificate) argued that the New York statute said nothing about a completion certificate serving as a substitute for statutory notice and concluded that the bank should have waited until the statutory period expired after it had sent notice before paying.<sup>79</sup> This dissenting opinion was adopted by the Appellate Division, but not unanimously,<sup>80</sup> at the second level of appeal.

Such a statute as New York's assumes that the waiver clause will be enforced if the notice provisions are complied with; the factual patterns emerging deal with estoppel arguments when the notice provisions are imperfectly met. Even when waiver clauses are expressly prohibited by legislation, the possibility of estoppel still exists.<sup>81</sup>

Incapacity to contract may be a real defense—that is, one assertable even against a holder in due course<sup>82</sup>—but estoppel has been utilized to bar even real defenses.<sup>83</sup> In *Rosman v. Cuevas*,<sup>84</sup> incapacity was pleaded

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<sup>77</sup> 55 Misc. 2d at —, 286 N.Y.S.2d at 729.

<sup>78</sup> *Id.*

<sup>79</sup> *Chase Manhattan Bank v. McLeish*, 55 Misc. 2d 1009, 1014, 286 N.Y.S.2d 727, 732 (Sup. Ct. 1968) (dissenting opinion).

<sup>80</sup> *Chase Manhattan Bank v. McLeish*, 30 App. Div. 2d 877, 293 N.Y.S.2d 713 (1968).

<sup>81</sup> UNIFORM CONSUMER CREDIT CODE § 1.103, for example, states that unless displaced by a particular provision of the Act, the principles of estoppel supplement its provisions.

<sup>82</sup> UNIFORM COMMERCIAL CODE §§ 3-305, 9-206 (1962 version).

<sup>83</sup> W. HAWKLAND, CASES AND MATERIALS ON COMMERCIAL PAPER AND BANK DEPOSITS 248 (1967).

<sup>84</sup> 176 Cal. App. 2d 867, 1 Cal. Rptr. 485 (Super. Ct. 1959).

as a defense to an action brought on a conditional sales contract for the purchase of a car. The obligor had been convicted of a felony, and a California statute<sup>85</sup> provided that a felony conviction destroys one's capacity to contract. An assignee of the contract argued that the fact the obligor signed the document worked an estoppel, and the trial court agreed. Holding that the public policy of the statute was paramount, the California appellate court reversed.

Usury—a statutory evil—is another type of defense that is sometimes classified as real. When the face of the contract itself revealed the usurious charge, an assignee's argument that the obligor was estopped to assert such a defense was unsuccessful in *San Joaquin Finance Corp. v. Allen*.<sup>86</sup>

In most jurisdictions there appears in one form or another a statute that authorizes assignments and provides that an assignee stands in the position of the assignor. These statutes were ordinarily thought of as procedural cures for the old common law rule that an assignee could not sue in his own name. Usually the statutes added language to the effect that the assignee, suing in his own name, was subject to the defenses available against his assignor.<sup>87</sup> With the development of the waiver clause in a typical retail installment sales contract, the question became: does the fact that the statutes mention defenses mean that no estoppel can operate against the obligor? In the leading case for the proposition that fraud in the inducement may be asserted against an assignee despite a waiver clause, *American National Bank v. A. G. Sommerville, Inc.*,<sup>88</sup> the California Supreme Court used such a statute to rule out the estoppel argument arising from the fact that the obligor had signed a contract containing a waiver-of-defense clause. Contract estoppel was not available because of the positive interdiction of the statute.<sup>89</sup> But the court conceded the possibility that other conduct by the obligor might work an estoppel and posed a fact situation in which, in response to an inquiry by the assignee as to whether the goods had been delivered, the obligor replied that they had been, when in fact they had not. The court suggested that in such a case estoppel would prevent the obligor from asserting the defense of non-delivery.<sup>90</sup>

When the defense was fraud, estoppel by contract also failed in the

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<sup>85</sup> CAL. CIV. CODE § 1556 (West 1954).

<sup>86</sup> 102 Cal. App. 400, 283 P. 117 (1929).

<sup>87</sup> *E.g.*, N.C. GEN. STAT. § 1-57 (1969).

<sup>88</sup> 191 Cal. 364, 216 P. 376 (1923).

<sup>89</sup> *Id.* at 370, 216 P. at 378.

<sup>90</sup> *Id.* at 373, 216 P. at 379.

New York case of *President and Directors of Manhattan Co. v. Monogram Associates, Inc.*<sup>91</sup> The court held that fraud vitiating the contract also vitiates the waiver-of-defense clause contained within it. It recognized, however, the possibility of estoppel by conduct and conceded that signing a contract with a waiver clause might be evidence of such conduct.

As indicated in *American National Bank*, acknowledgments that goods have been delivered when in fact they have not raise estoppel problems. In *Malas v. Lounsbury*<sup>92</sup> and *Thorp Finance Corp. v. Le Mire*,<sup>93</sup> two Wisconsin cases, the obligors acknowledged delivery of goods under sales contracts that contained waiver clauses. Both obligors knew when they acknowledged delivery that they had not yet received the goods. The obligor in *Malas* was successful in asserting the claim of non-delivery, but strong dictum in *Le Mire*, referring favorably to the dissenting opinion in *Malas*, indicated that the obligor may be estopped in such situations.<sup>94</sup>

A case widely cited for the proposition that it is against the public policy of Massachusetts to enforce waiver-of-defense clauses is *Quality Finance Co. v. Hurley*.<sup>95</sup> It is, for example, cited by the drafters of the Uniform Consumer Credit Code as typical of a growing body of law that invalidates waiver clauses in consumer credit sales contracts.<sup>96</sup> But while there is dictum in the opinion to that effect, there is also dictum asserting that estoppel by conduct may cut off otherwise meritorious defenses.<sup>97</sup> *Hurley* involved the typical motor vehicle transaction; the obligor acknowledged receipt of the car, and the contract included a waiver clause. Apparently believing that the car had never reached the buyer-obligor, the trial judge ruled in his favor and denied certain rulings requested by the finance company, one of which would have required a conclusion of law to the effect that the obligor was estopped by his conduct to assert the defense of non-delivery.

The Supreme Judicial Court of Massachusetts agreed with the trial judge's ruling on the estoppel point;<sup>98</sup> estoppel is a question of fact, not of law. Only if the trier of fact had found such facts as would have given

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<sup>91</sup> 276 App. Div. 766, 92 N.Y.S.2d 579 (1949), *appeal dismissed*, 300 N.Y. 677, 91 N.E.2d 328 (1950).

<sup>92</sup> 193 Wis. 531, 214 N.W. 332 (1927).

<sup>93</sup> 264 Wis. 220, 58 N.W.2d 641 (1953).

<sup>94</sup> 264 Wis. at 224-25, 58 N.W.2d at 643.

<sup>95</sup> 337 Mass. 150, 148 N.E.2d 385 (1958).

<sup>96</sup> UNIFORM CONSUMER CREDIT CODE § 2.404, comment to alternative A (1968 version).

<sup>97</sup> 337 Mass. at 156, 148 N.E.2d at 390.

<sup>98</sup> *Id.* at 156, 148 N.E.2d at 390.

rise to an estoppel could the plaintiff have recovered. The high court also commented on the plaintiff's argument that the waiver clause prevented the defendant from asserting the non-delivery. First, non-delivery constitutes a total failure of consideration, and the good faith assignee takes subject to that kind of defense;<sup>99</sup> second, Massachusetts had held that advance waivers of statutes of limitations were against public policy, and the waiver-of-defense clause is similar;<sup>100</sup> and third, the statute giving the assignee a right to sue but subjecting him to the defenses available against the assignor, while primarily a procedural statute, adds weight to the conclusion that the waiver clause should be disregarded as contrary to public policy.<sup>101</sup> In sum, *Hurley* may represent a decision that places waiver clauses in limbo, but it also represents a decision explicitly recognizing that in certain situations estoppel by conduct may be available to an assignee.

*Hurley* should be compared with another, more recent decision in Massachusetts, *Universal C.I.T. Credit Corp. v. Ingel*,<sup>102</sup> in which a finance company successfully recovered on a motion for directed verdict from obligors who had purchased aluminum siding that proved to be defective. One key reason that the finance company won in *Ingel* was because it was a holder in due course of a negotiable promissory note signed by the obligors in addition to a completion certificate. Form succeeded where contract failed. Must it be added that the distinction is specious when viewed from the consumer's angle?

It might be argued that those cases invalidating waiver-of-defense clauses on grounds of public policy also represent application of the principle that estoppel by contract requires a reasonable reliance on the contract promise. Financing agencies' executives surely are aware of consumers' behavior—that they do not read such clauses before signing or, when they do, that they do not understand them or sign them anyway for reasons extraneous to the contract. Reliance by assignees in the business of buying commercial paper on clauses in contracts signed by persons in ordinary consumer transactions does not appear reasonable in the light of the facts surrounding such transactions. This point is emphasized by comparing consumer transactions with what might be called clear-cut commercial trades in which the parties understand rather

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<sup>99</sup> *Id.* at 153, 148 N.E.2d at 388.

<sup>100</sup> *Id.* at 154-55, 148 N.E.2d at 389.

<sup>101</sup> *Id.* at 155, 148 N.E.2d at 389.

<sup>102</sup> 347 Mass. 119, 196 N.E.2d 847 (1964).

plainly the nature of the exchange. A good example of the latter is the modern business lease-financing device.<sup>103</sup>

In many cases, a completion certificate has been signed at the time of sale, and the need to protect the consumer from the wiles of the super-salesman comes into play.<sup>104</sup> But a wide range of human conduct follows that point in time, and some of it may well work against the consumer. An obvious situation is one in which the financing agency telephones the consumer and asks if the goods have been delivered and are satisfactory. A favorable reply by the consumer could reasonably lead a finance company to purchase paper from a new dealer.

Consider *Lundstrom v. Radio Corp. of America*,<sup>105</sup> a 1965 decision from Utah. Utah Electronics sold color television sets and had developed, as part of its sales techniques, a typical referral scheme. For each prospective purchaser's name furnished, the buyer would receive \$50. These referral plans are widespread and occasionally a buyer actually does receive the amount promised—but not often. Finance companies know of this proclivity and take steps to protect themselves. In the Utah case, it appears that the financing agency required the dealer to make a voice recording of the buyer telling the agency that he understood that the referral scheme was not a part of the sales transaction and that the conditional sales contract was a separate matter. Further, the finance company required the buyer to submit an acknowledgment of receipt of the set. Finally, before purchasing the paper, it called the buyer and confirmed his understanding of the nature of the transaction. In addition to all these precautions, the contract contained the usual waiver-of-defense clause. It seems small wonder that the finance agency won a jury verdict when a buyer was sued for non-payment.<sup>106</sup> Pointing out that Utah Electronics had paid only one purchaser out of five hundred for referrals, the buyer had defended on grounds of fraud. The Utah Supreme Court upheld the jury verdict in a decision discarding the argument that all the preparation by the finance company demonstrated that it was not a bona fide purchaser of the paper. The court held that the statute providing that the assignee takes subject to defenses did not override the waiver clause.

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<sup>103</sup> See *Trans-American Leasing Corp. v. Van's Realty Co.*, 91 Idaho 510, 427 P.2d 284 (1967).

<sup>104</sup> E.g., *Fidelity Trust Co. v. Gardiner*, 191 Pa. Super. 17, 155 A.2d 405 (1959).

<sup>105</sup> 17 Utah 2d 114, 405 P.2d 339 (1965).

<sup>106</sup> *Id.* at 114-15, 405 P.2d at 340.

In New Jersey, *Unico v. Owen*<sup>107</sup> has had its effect on two trial judges in that state. In both cases, *HIMC Investment Co. v. Siciliano*<sup>108</sup> and *Toker v. Perl*,<sup>109</sup> estoppel arguments by the assignee were rejected on the strength of *Owen*, which did not explicitly discuss estoppel at all, but is a strong consumer-oriented decision. In *Siciliano*, the obligor had signed a closing statement in which he swore that there no defenses, set-offs or counterclaims. But since the entire transaction violated the regulatory provisions of the New Jersey Second Mortgage Loan Act,<sup>110</sup> the policy of that legislation was held to override any estoppel arising from the obligor's act of swearing to no defenses. In *Toker*, the assignee argued that the obligors were negligent in not reading the papers they signed, one of which was a contract for the purchase of a food freezer. The obligors had wanted only a frozen food delivery service and not the home freezer that was included in the merchandising scheme. Negligence might work an estoppel, held the court, but not in this particular case. Perhaps the court was impressed by the fact that the negotiations had taken place late in the evening, that the salesman had covered the freezer contract so that the signers could only see the signature line (the delivery-service contract having been placed on top), and that the obligors had taken immediate steps to cancel the contract upon discovering that they had been duped. *Unico* was cited as having adopted the principle articulated by Mr. Justice Frankfurter in *United States v. Bethlehem Steel Corp.*:

But is there any principle which is more familiar or more firmly embedded in the history of Anglo American law than the basic doctrine that the courts will not permit themselves to be used as instruments of inequity and injustice? Does any principle in our law have more universal application than the doctrine that the courts will not enforce transactions in which the relative positions of the parties are such that one has unconscionably taken advantage of the necessities of the other?<sup>111</sup>

#### FRAUD, BREACH OF WARRANTY, AND FAILURE OF CONSIDERATION

Two early-twentieth-century cases are ordinarily cited for the proposition that breach of warranty may not be asserted against a good-faith

<sup>107</sup> 50 N.J. 101, 232 A.2d 405 (1967). The case is discussed at pp. 512-13 *supra*.

<sup>108</sup> 103 N.J. Super. 27, 246 A.2d 502 (Super. Ct. 1968).

<sup>109</sup> 103 N.J. Super. 500, 247 A.2d 701 (Super. Ct. 1968).

<sup>110</sup> 103 N.J. Super. at 37-38, 246 A.2d at 507-08.

<sup>111</sup> 315 U.S. 289, 326 (1942).

assignee but that fraud in the inducement may be so asserted despite the presence of a waiver-of-defense clause.<sup>112</sup> Subsequent decisions have continued the distinction,<sup>113</sup> although some courts have used the "interwoven" doctrine (or similar devices) in borderline situations to permit all defenses on the theory that the assignee or holder in due course was not in good faith.<sup>114</sup> Some courts base the distinction on the principle that fraud vitiates the entire contract, including the waiver clause,<sup>115</sup> while others hold simply that the waiver clause is unenforceable without even considering the nature of the defense.<sup>116</sup> In any event, waiver clauses will not preclude an obligor from asserting the defense of fraud; only matters of proof present difficulties.<sup>117</sup>

In the case of negotiable commercial paper, however, neither fraud in the inducement, nor breach of warranty, nor, for that matter, total failure of consideration is traditionally available to the obligor when the good-faith assignee is a holder in due course.<sup>118</sup> Ordinarily, the only defenses available to an obligor as against a holder in due course are the real defenses—those that relate in one way or another to the absence of "legal" contractual intent.<sup>119</sup> As hornbook law teaches, fraud in the inducement

<sup>112</sup> *American Nat'l Bank v. A. G. Sommerville, Inc.*, 191 Cal. 364, 216 P. 376 (1923); *Anglo-California Trust Co. v. Hall*, 61 Utah 223, 211 P. 991 (1922).

<sup>113</sup> *United States ex rel. Adm'r of Fed. Housing Admin. v. Troy-Parisian, Inc.*, 115 F.2d 224 (9th Cir. 1940); *San Francisco Sec. Corp. v. Phoenix Motor Co.*, 25 Ariz. 531, 220 P. 229 (1923); *Refrigeration Discount Corp. v. Haskew*, 194 Ark. 549, 108 S.W.2d 908 (1937); *Pacific Acceptance Corp. v. Whalen*, 43 Idaho 15, 248 P. 444 (1926); *Cappa v. Steve Alois-Ford, Inc.*, 51 Misc. 2d 161, 272 N.Y.S.2d 874 (Sup. Ct. 1966); *Nassau Discount Corp. v. Allen*, 44 Misc. 2d 1007, 255 N.Y.S.2d 608 (N.Y. City Civ. Ct. 1965); *Glen Falls Nat'l Bank & Trust Co. v. Sansivere*, 136 N.Y.S.2d 672 (Saratoga County Ct. 1955).

<sup>114</sup> *American Plan Corp. v. Woods*, 16 Ohio App. 2d 1, 240 N.E.2d 886 (1968); *Norman v. World Wide Distrib., Inc.*, 202 Pa. Super. 53, 195 A.2d 115 (1963); *Fidelity Trust Co. v. Gardiner*, 191 Pa. Super. 17, 155 A.2d 405 (1959); *Schow v. Guardtone, Inc.*, 18 Utah 2d 135, 417 P.2d 643 (1966).

<sup>115</sup> *President & Directors of Manhattan Co. v. Monogram Associates, Inc.*, 276 App. Div. 766, 92 N.Y.S.2d 579 (1949), *appeal dismissed*, 300 N.Y. 678, 91 N.E.2d 328 (1950); *Sterling Commercial Corp. v. White*, 5 U.C.C. Rep. Serv. 516 (N.Y. Sup. Ct. 1968) (dictum).

<sup>116</sup> *Equipment Acceptance Corp. v. Arwood Can Mfg. Co.*, 117 F.2d 442 (6th Cir. 1941); *Industrial Loan Co. v. Grisham*, 115 S.W.2d 214 (St. Louis, Mo. Ct. App. 1938); *Progressive Fin. & Realty Co. v. Stempel*, 95 S.W.2d 834 (St. Louis, Mo. Ct. App. 1933).

<sup>117</sup> *First Acceptance Corp. v. Kennedy*, 95 F. Supp. 861 (N.D. Iowa 1951), *rev'd*, 194 F.2d 819 (8th Cir. 1952); *James Talcott, Inc. v. Finley*, 389 P.2d 988 (Okla. 1964); *Lundstrom v. RCA*, 17 Utah 2d 114, 405 P.2d 339 (1965).

<sup>118</sup> *Universal C.I.T. Credit Corp. v. Ingel*, 347 Mass. 119, 196 N.E.2d 847 (1964); *UNIFORM COMMERCIAL CODE* § 3-305.

<sup>119</sup> *UNIFORM COMMERCIAL CODE* §§ 3-305(2)(a)-(2)(e).



is a personal defense and thus not available, but fraud in the factum is a real defense and is available.<sup>120</sup> An exception has been carved out of the real defense of fraud in the factum—negligence on the part of the signer will permit the holder in due course to recover.<sup>121</sup>

For example, in a 1964 New Mexico decision, *Burchett v. Allied Concord Finance Corp.*,<sup>122</sup> purchasers of aluminum siding for their homes signed without reading what the salesman told them were the necessary papers. The "papers" included a negotiable promissory note and a mortgage on any real property that they owned. The finance company purchased the note and mortgage from the seller, apparently under circumstances that made it impossible to attack the finance agency's status as holder in due course. The New Mexico Supreme Court reversed a trial court judgment for the obligors on the ground that their signing in ignorance of the contents of the agreements was not excusable.<sup>123</sup> The court reasoned that since the obligors were reasonably well-educated (through the ninth grade) and since they had been gainfully employed and owned modest homes, they had sufficient experience at least to ask questions about the papers.

By contrast, in an Ohio case involving the purchase of a water softener, an appellate court found for the obligor on the strength of her testimony that she had not intended to sign a promissory note but thought that she was signing an advertising contract.<sup>124</sup> The lack of concern about the consumer's "negligence" in that opinion is commendable.

These cases illustrate another area in which the rules of negotiability are producing hardships for the consumer while aiding the slick-talking salesman. At a minimum, it ought to be for the trier of fact to determine whether the trickery of the salesman offsets the negligence of the signer.<sup>125</sup> One wonders why the New Mexico court did not take advantage of the explicit language of the Uniform Commercial Code to the effect that if a party has been induced to sign an instrument while having neither knowledge nor reasonable opportunity to obtain knowledge of its char-

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<sup>120</sup> W. BRITTON, *BILLS AND NOTES* § 130, at 347 (2d ed. 1961).

<sup>121</sup> *Id.*

<sup>122</sup> 74 N.M. 575, 396 P.2d 186 (1964).

<sup>123</sup> *Id.* See UNIFORM COMMERCIAL CODE § 3-305, Comment 7 (commenting on (2)(b) of that section). The comment asserts that the theory of the real defense is that the obligor did not intend to sign such an instrument at all and that this rationale is extended to instruments signed with knowledge that they are negotiable but without knowledge of their essential terms.

<sup>124</sup> *American Plan Corp. v. Woods*, 16 Ohio App. 2d 1, 240 N.E.2d 886 (1968).

<sup>125</sup> W. BRITTON, *BILLS AND NOTES* § 130, at 358 (2d ed. 1961).

acter or its essential terms the defense of fraud is available against a holder in due course.<sup>126</sup> Perhaps the Burchetts had the opportunity to obtain knowledge of the character of the instrument they were signing; that the salesman would ever reveal "its essential terms" is another matter entirely, and to expect the ordinary consumer consciously to know more than that he is signing a legally significant document that will help put aluminum siding on his home is to expect more than normal experience dictates. Of course, one *should* know what he is signing. But the whole thrust of the idea behind consumer protection is that, as a practical matter, the buyer is unlikely to know. Under the circumstances of most sales to consumers (high-pressure techniques, fine print on forms, the number of forms presented, etc.), they cannot be expected to exercise a reasoned judgment even if they have ostensibly acquired certain knowledge. The freedom to contract should not be the freedom to bamboozle.

What has been said about the exception for the real defense of fraud in the factum should apply as well to fraud in the inducement. If a contract waiver is unenforceable because of fraudulent inducement, there is no greater reason to hold the signer of a negotiable instrument to be bound. The application of formality without social utility is stupidity. In consumer transactions, fraud in the inducement should be a defense as against transferees whether the paper transferred is negotiable or merely contains a waiver clause.

Interestingly, in *Unico v. Owen*,<sup>127</sup> the New Jersey Supreme Court said: "We reserve specifically the question whether, when the buyer's claim is breach of warranty as distinguished from failure of consideration, the seller's default as to the former may be raised as a defense against the financier."<sup>128</sup> Thus, in one of the strongest consumer-oriented decisions yet handed down, there is a specific reservation of whether, at least insofar as negotiable paper is concerned, the defense of breach of warranty, as opposed to failure of consideration, may nevertheless be cut off.

Part of the problem facing the consumer's lawyer lies in the ambiguity of the words. A breach of promise is a failure to receive that which one bargained for, whether one calls it breach of warranty or failure of consideration.<sup>129</sup> It may be that the degree of breach is what is being measured by the terms in a manner somewhat analogous to the testing

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<sup>126</sup> UNIFORM COMMERCIAL CODE § 3-305(2) (c).

<sup>127</sup> 50 N.J. 101, 232 A.2d 405 (1967). See pp. 512-13 *supra*.

<sup>128</sup> *Id.* at 123, 232 A.2d at 417.

<sup>129</sup> S. WILLISTON, LAW OF CONTRACTS § 814, at 697-99 (3d ed. 1962).

of breach as excuse for the other party's nonperformance in the ordinary contract situation.<sup>130</sup> Consider *Pennsylvania Exchange Bank v. Kenmore Furniture Co.*<sup>131</sup> In this case, defendant obligor had purchased an air conditioning system from a seller who was on the verge of insolvency. The buyer sued the seller in municipal court and obtained rescission of the contract and a return of the down payment. Subsequently, an assignee of the sales contract, which contained a waiver clause, sued the buyer—and won on summary judgment! The buyer had to pay for an air conditioning system that he did not own. A dissenting judge thought that a reasonable distinction could be made in that the waiver clause might be effective to exclude defenses based on the failure of the air conditioner to perform sometime after the deal had been consummated, but that a defense arising before the assignment in the nature of a total failure of consideration—as when the system was not delivered at all—should override the waiver clause.<sup>132</sup>

Several decisions discuss the distinction suggested by the dissenting judge, but no pattern is discernible in terms of the labels used.<sup>133</sup> Sometimes the degree of the breach—such as total failure to deliver goods or total failure of the goods to work after delivery—seems to influence the decision whether to permit the obligor to assert his defense.<sup>134</sup> Most would agree that such activity as the non-delivery of goods purchased or the delivery of goods that fail to work at all comes perilously close to fraudulent conduct on the part of the seller.<sup>135</sup>

There may be some utility in the use of the concept of breach of warranty to enable the courts to exclude from protection of the developing consumer rules the buyer who upon finding that he cannot pay for the

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<sup>130</sup> 3A A. CORBIN, CONTRACTS § 659 (1960).

<sup>131</sup> 279 App. Div. 899, 111 N.Y.S.2d 194 (1952).

<sup>132</sup> *Id.* at —, 111 N.Y.S.2d at 196 (dissenting opinion).

<sup>133</sup> Defense based on breach of warranty barred: *Refrigeration Discount Corp. v. Haskew*, 194 Ark. 549, 108 S.W.2d 908 (1937); *Cappa v. Steve Alois-Ford, Inc.*, 51 Misc. 2d 161, 272 N.Y.S.2d 874 (Sup. Ct. 1966). Breach-of-warranty defense permitted: *San Francisco Sec. Corp. v. Phoenix Motor Co.*, 25 Ariz. 531, 220 P. 229 (1923).

Failure-of-consideration defense permitted: *Equipment Acceptance Corp. v. Arwood Can Mfg. Co.*, 117 F.2d 442 (6th Cir. 1941); *C.I.T. Corp. v. Hetland*, 143 N.W.2d 94 (N.D. 1966); *American Plan Corp. v. Woods*, 16 Ohio App. 2d 1, 240 N.E.2d 886 (1968). Failure-of-consideration defense barred: *Commercial Credit Corp. v. Biagi*, 11 Ill. App. 2d 80, 136 N.E.2d 580 (1956); *Universal Credit Co. v. Cushing Motor Co.*, 183 Okla. 63, 79 P.2d 1014 (1938).

<sup>134</sup> *E.g.*, *Progressive Fin. & Realty Co. v. Stempel*, 198 Mo. App. 384, 95 S.W.2d 834 (1933).

<sup>135</sup> Cases cited note 133 *supra*.

goods purchased cars about the quality.<sup>136</sup> But the social danger implicit in the imposition on consumers of shoddy goods is so much greater than any potential loss resulting from the belated invention of the disgruntled buyer that courts ought to proceed quite slowly in permitting any defense to be cut off.

### LEGISLATIVE RESPONSE

The most striking feature about the legislative response to the cutting off of the defenses of a consumer or purchaser of goods on an installment plan is the variety of approaches. Many states, of course, have had no statutory treatment of the issue except that provided by section 9-206 of the Uniform Commercial Code.<sup>137</sup> Some states have severely restricted or prohibited outright both waiver clauses and negotiability;<sup>138</sup> others have barred one but not the other;<sup>139</sup> still others permit waiver

<sup>136</sup> *Glen Falls Nat'l Bank & Trust Co. v. Sansivere*, 136 N.Y.S.2d 672 (Saratoga County Ct. 1955); *James Talcott, Inc. v. Finley*, 389 P.2d 988 (Okla. 1964).

<sup>137</sup> Subject to any statute or decision which establishes a different rule for buyers or lessees of consumer goods, an agreement by a buyer or lessee that he will not assert against an assignee any claim or defense which he may have against the seller or lessor is enforceable by an assignee who takes his assignment for value, in good faith and without notice of a claim or defense, except as to defenses of a type which may be asserted against a holder in due course of a negotiable instrument under the Article on Commercial Paper (Article 3). A buyer who as part of one transaction signs both a negotiable instrument and a security agreement makes such an agreement.

UNIFORM COMMERCIAL CODE § 9-206(1).

<sup>138</sup> CAL. CIV. CODE § 1804.2 (West Supp. 1969) (invalidating waiver clause in retail installment contracts); CAL. CIV. CODE § 1810.7 (West Supp. 1969) formerly CAL. CIV. CODE § 1810.9 (barring negotiability of retail installment "accounts"); HAWAII REV. LAWS § 476-18 (1968) (invalidating waiver clause and barring negotiability of retail installment contracts); MASS. GEN. LAWS ANN. ch. 255D, § 10(6), ch. 255, § 12C (1968) (prohibiting negotiability when consumer goods are involved); N.Y. PERS. PROP. LAW § 403(1) (McKinney 1962) (prohibiting negotiability in situations involving retail installment contracts and obligations), § 403(3)(g) (McKinney 1962) (making waivers ineffective when contract is executory and is for services); UTAH CODE ANN. §§ 70B-2-403 & -404 (Supp. 1969) (adopting Uniform Consumer Credit Code provisions); WASH. REV. CODE ANN. § 63.14.020 (Supp. 1969) (prohibiting negotiability in retail-installment transactions), § 63.14.150 (Supp. 1969) (prohibiting waivers in retail installment contracts).

<sup>139</sup> ALASKA STAT. § 45.10.140 (1962) (waivers barred in retail installment sales); MD. ANN. CODE art. 83, § 147 (1965) (negotiability prohibited in retail installment transactions); NEV. REV. STAT. § 97.275 (1967) (waivers invalid); N.M. STAT. ANN. § 50-16-5 (Supp. 1969) (waivers prohibited); N.D. CENT. CODE § 51-07-09 (1959) (waivers barred); OKLA. STAT. ANN. tit. 14A, § 2-403 (Supp. 1969) (Uniform Consumer Credit Code section prohibiting negotiability); PA. STAT. tit. 69, § 615(G) (1965) (negotiability prohibited in motor-vehicle sales),

clauses if notice is given the buyer and he fails to respond within a given period;<sup>140</sup> and some have explicitly validated the cutting off of defenses.<sup>141</sup> More than one state has barred waivers *or* negotiability and at the same time, in one manner or another, recognized explicitly the validity of the concept not barred.<sup>142</sup> Other states have barred the cutting off of defenses for certain classes of goods while either ignoring the problem or explicitly permitting cutoffs for other classes.<sup>143</sup>

The Uniform Commercial Code expressly recognizes both negotiability and waivers of defenses—the former only when the formalities of the statute have been complied with and the holder meets the test of a holder in due course; the latter only when there is no contrary statute or case

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tit. 73, § 500-207 (Supp. 1969) (negotiability prohibited in home-improvement transactions); R.I. GEN. LAWS ANN. § 6-27-6 (Special Supp. 1968, vol. 2) (negotiability severely restricted); VT. STAT. ANN. tit. 9, § 2455 (Supp. 1969) (negotiability prohibited).

<sup>140</sup> CAL. CIV. CODE § 2983.5 (West Supp. 1969) (motor-vehicle sales only); DEL. CODE ANN. tit. 6, § 4312 (Supp. 1968) (retail installment sales); MICH. STAT. ANN. § 19.416 (115) (Supp. 1969) (retail-installment sales), § 19.417 (208) (Supp. 1969) (home-improvement installment contracts); N.Y. PERS. PROP. LAW § 403(3)(a) (McKinney Supp. 1969) (retail-installment sales); PA. STAT. tit. 69, § 1402 (Supp. 1969) (goods and services installment sales, forty-five-day-notice period), tit. 73, § 500-208 (Supp. 1969) (home-improvement transaction, fifteen-day-notice requirement); TEX. REV. CIV. STAT. ANN. art. 5069-6.07 (Supp. 1969) (retail-installment sales); WIS. STAT. ANN. § 218.01(6)(e) (1957) (retail-installment sales).

<sup>141</sup> ALASKA STAT. § 45.10.010(b) (1962) (express negation of the conditional-promise doctrine that would otherwise destroy negotiability in retail installment sales); CONN. GEN. STAT. ANN. § 42-136(d) (Supp. 1969) (a promissory note issued by buyer in home-solicitation transaction deemed an assignment; but note issued in violation enforceable as a negotiable instrument by holder in due course); MICH. STAT. ANN. § 23.628(14)(f) (1957) (waivers prohibited in motor-vehicle retail installment sales contracts, but nothing shall impair rights of holder in due course of negotiable instrument); MO. ANN. STAT. § 408.260 (Supp. 1969) (negotiability expressly protected if note evidences a retail time contract); ORE. REV. STAT. § 83.650(2) (1967) (negotiability expressly granted motor-vehicle installment-contract notes); R.I. GEN. LAWS ANN. § 6-27-6 (Special Supp. 1968, vol. 2) (recognition of holder in due course possibility but prohibiting the issuance of negotiable consumer notes); VA. CODE ANN. § 6.1-356 (Supp. 1968) (nothing in consumer-credit law shall affect the validity or enforceability of any contract or obligation except as provided by that law, and there are no provisions concerning cutoffs).

<sup>142</sup> Typically one statute will permit waivers of defenses if the assignee notifies the buyer but elsewhere will prohibit negotiable instruments in certain transactions. Compare PA. STAT. tit. 69, § 1402 (Supp. 1969) with PA. STAT. tit. 69, § 615(G) (1965); and ALASKA STAT. § 45.10.010(b) (1962) with ALASKA STAT. § 45.10.140 (1962).

<sup>143</sup> In Michigan, for example, notice-type waivers are validated in retail installment sales contracts, but prohibited in motor-vehicle transactions. Nothing is said about negotiability in the former, and it is expressly recognized in the latter. See MICH. STAT. ANN. § 19.416(115) (Supp. 1969).

decision with respect to consumer goods and the assignee has taken for value and in good faith.<sup>144</sup> Thus, for every transaction not covered by specific legislation<sup>145</sup> or judicial precedent concerning the prohibition or the limitation of waivers or negotiability, there is a legislative rule in the jurisdictions that have adopted the Code that can be said to authorize the cutting-off of defenses. In early drafts of the Code, a thorough coverage of consumer protection had been envisioned. The 1952 draft of the UCC made waivers in consumer contracts unenforceable, and defenses were available even as against a holder in due course of a negotiable promissory note if he attempted to enforce the security interest against the goods themselves.<sup>146</sup> In the negotiability article of that same draft, the objective standard of good faith also appeared.<sup>147</sup> The presence of these and other consumer-protection provisions in the Code created a violent controversy that eventually led to their elimination. It is now difficult indeed to find any protection for the consumer or installment buyer under the UCC.<sup>148</sup> Section 2-302, which permits a court to judge a sales contract to be unconscionable, is all the more conspicuous for this reason and so is its omission from the North Carolina version of the Code.

Today, the desire for uniformity *and* for consumer protection finds one outlet in the Uniform Consumer Credit Code, promulgated in 1968 by the National Conference of Commissioners on Uniform State Laws. (The Federal Truth in Lending Act<sup>149</sup> has no provision with respect to waivers or negotiability.) As of this writing, Oklahoma and Utah have already adopted the UCCC, and more states will undoubtedly follow. The UCCC contains treatment of both negotiability and waiver. In the case of waiver, it gives the legislators a choice of approach—outright prohibition or validation upon notice of assignment and no response from the notified buyer. Its section concerning negotiability is at first reading a puzzle, because, as in some of the state statutes already mentioned, it appears to bar negotiability and recognize a holder in due course in the same section. It reads:

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<sup>144</sup> UNIFORM COMMERCIAL CODE art. 3 & § 9-206.

<sup>145</sup> See *id.* § 9-203(2).

<sup>146</sup> *Id.* § 9-206 (1952 version).

<sup>147</sup> *Id.* § 3-302(1)(b) (1952 version).

<sup>148</sup> 2 G. GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY § 41.5 (1965); Skilton & Helstad, *supra* note 16, at 1465, 1468.

<sup>149</sup> 15 U.S.C.A. §§ 1601-65 (Supp. 1970).

In a consumer credit sale or consumer lease, other than a sale or lease primarily for an agricultural purpose, the seller or lessor may not take a negotiable instrument other than a check, as evidence of the obligation of the buyer or lessee. A holder is not in good faith if he takes a negotiable instrument with notice that it is issued in violation of this section.<sup>150</sup>

What is prohibited is not the cutting-off of defenses, but the taking of a negotiable promissory note that would cut off defenses in the hands of a holder in due course. The relevant comment of the drafters suggests that since the financial community knows about the prohibition, professional financiers buying commercial paper (from sellers of consumer goods on time) would not normally qualify as holders in due course. This general knowledge apparently would be tested by an objective standard and not a subjective one; actual lack of knowledge by the particular office manager buying the challenged paper would seem to be irrelevant. The logic underlying this section—that a seller of consumer goods cannot take negotiable paper, but even if he does, professional financiers cannot be holders in due course although others, particularly second and third transferees, may be—gives meaning to a rather ambiguous section of many state installment sales acts that simply provide that the seller may not require, nor may the contract “entail,” the execution of a negotiable instrument.<sup>151</sup> Perhaps under such statutes there may be a holder in due course, but not one who knows, or should know, about the restriction. This concept strikes one as an interesting attempt to preserve the benefits of negotiability while at the same time attempting to protect the consumer.

As to waivers of defenses under the UCCC, Alternative *A* of section 2.404 makes the assignee of a consumer-credit sale or lease subject to all claims and defenses of the buyer or lessee against the seller or lessor arising out of the sale or lease, but liability is limited to the amount due the assignee on the obligation at the time of the assertion of the claim or defense. Alternative *B* effectuates waiver-of-defense clauses if the assignee is not “related”<sup>152</sup> to the seller, if the assignee gives prescribed notice of the assignment to the buyer, and if, within three months of receiving notice of the assignment, the buyer does not respond in writing to give

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<sup>150</sup> UNIFORM CONSUMER CREDIT CODE § 2.403.

<sup>151</sup> *E.g.*, DEL. CODE ANN. tit. 6, § 4342 (Supp. 1968).

<sup>152</sup> Section 1.301(14) of the UCCC defines the term “person related to” broadly. It includes blood relatives, relatives by marriage, and, if organizations are concerned, persons exercising control over them.

notice of any claim or defense. Utah has adopted Alternative *A*, which prohibits waivers outright;<sup>153</sup> Oklahoma has adopted Alternative *B*, but has shortened the time for buyer response to notice of assignment to thirty days.<sup>154</sup> The validation-upon-notice statutes, in the states that have adopted them as part of their regulation of retail installment sales or credit transactions, are quite similar to the UCCC's Alternative *B* in format although in details there is a wide range.<sup>155</sup>

By judicial decision and by many statutes, an assignee to cut off defenses must take in good faith and for value. Some statutes omit specific reference to this basic assumption, others merely describe it, and still others spell out the requirement in some detail.<sup>156</sup> The UCCC alternative that validates waivers upon notice from the assignee describes the meaning of good faith. The assignee may not be "related" to the assignor. Further, if the assignee has knowledge or, from his course of dealing with the assignor, notice of substantial complaints by other buyers or lessees about the assignor's failure or refusal to perform his contracts or to remedy his defaults within a reasonable time, the assignee cannot take in good faith.<sup>157</sup> The Illinois notice-validation section also spells out in great detail those facts that, if present, destroy the assignee's good-faith status.<sup>158</sup>

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<sup>153</sup> UTAH CODE ANN. § 70B-2-404 (Supp. 1969).

<sup>154</sup> OKLA. STAT. ANN. tit. 14A, § 2.404 (Supp. 1969).

<sup>155</sup> See note 140 *supra*.

<sup>156</sup> See discussion of GOOD FAITH ASSIGNEE p. 509 *supra*.

<sup>157</sup> UNIFORM CONSUMER CREDIT CODE § 2.404(2) (Alternative B).

<sup>158</sup> ILL. ANN. STAT. ch. 121½, § 517 (Smith-Hurd Supp. 1969) provides:

An agreement by a buyer that he will not assert against the assignee or the holder of a retail installment contract executed by the buyer any claim or defense which he may have against the seller and the rights of a holder in due course of any negotiable note executed in connection with a retail installment contract are enforceable by an assignee or holder who takes his assignment or indorsement for value in good faith and without notice of a claim or defense unless:

(a) the assignee or holder is an affiliate of the seller. "Affiliate" includes a parent or subsidiary corporation, any person holding substantial common ownership of stock of the assignee and the seller and any person having the common ownership of the legal or commercial entities of assignee and seller;

(b) The assignee or the holder has actual knowledge or has received notice before the contract or note is acquired (1) of repetitive complaints of a substantial nature by other buyers to any governmental agency that the seller has failed or refused to perform his agreements with such buyers; and (2) of the failure of the seller to perform his agreements with such buyers within a reasonable time after the governmental agency has determined that the complaints are well founded and has notified seller thereof, and the assignee, if known; or

(c) the assignee or the holder has actual knowledge or has received notice



On the other hand, the Michigan statute, as some others, does not mention "good faith" or refer to waiver clauses. It simply states that an assignment will cut off defenses if notice is given to the buyer and no response is received within fifteen days.<sup>159</sup>

A word needs to be said about the piecemeal nature of most statutory schemes. The typical enactment involves a good deal more than merely the problem of cutting off defenses. Legislators in such acts attempt to guarantee to a delineated group certain legal protections that have been deemed needed. A touch of cynicism is helpful in considering this legislation. The legal sanction of the cash-price, time-price doctrine as a method of extracting sizeable sums of money from the buyer, as well as the legality of add-on interest—both being substantial elements of such acts—is a high price for the buyer to pay for certain disclosure provisions and for the various prohibitions against such terms as the power to confess judgments.<sup>160</sup> But if the local act permits the retention of defenses against assignees or holders in due course in ordinary consumer transactions, quite an arrow has been added to the buyer's quiver.<sup>161</sup>

The problem for the legislative draftsman is, of course, how to express in written language the exact scope of human conduct proscribed. The typical act attempts to achieve this goal by prohibiting certain clauses in certain kinds of contracts. In Michigan, for example, no "retail installment contract or retail charge agreement" shall contain any provision by which the buyer agrees not to assert against the seller, or against an assignee, a claim or defense arising out of the sale.<sup>162</sup> Another section, however, validates waiver clauses when notice is given.<sup>163</sup> The interplay of definitions limits the regulation of waiver clauses to a contract concerning the sale of goods or services on credit, but only if they are purchased primarily for personal, household, or family use, and not "for commercial or business use."<sup>164</sup> The Michigan statute specifically ex-

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from its course of dealing with the seller or from its own records of substantial complaints by other buyers that seller has failed or refused to perform his agreements with such buyers within a reasonable time after such complaints are made.

<sup>159</sup> MICH. STAT. ANN. § 19.416(115) (d) (Supp. 1969).

<sup>160</sup> See the Kansas Sales Finance Act, KAN. STAT. ANN. §§ 16-501 to -514, (1964), as a prime example of this type of legislation.

<sup>161</sup> However, the Kansas Sales Finance Act, *id.*, does not prohibit waivers.

<sup>162</sup> MICH. STAT. ANN. § 19.416(114) (f) (Supp. 1969).

<sup>163</sup> *Id.* § 19.416(115).

<sup>164</sup> MICH. STAT. ANN. § 19.416(114) (Supp. 1969) provides:

No retail installment contract or retail charge agreement shall contain any provision by which:

cludes motor vehicles,<sup>165</sup> but statutes in other states apply to "all goods" and some—as Michigan's—include consumer services as well.<sup>166</sup>

The exclusion of automobiles usually comes about because the retail installment purchase of a car is regulated specifically by another earlier statute—in Michigan, for example, the Motor Vehicle Sales Finance Act.<sup>167</sup> A section of that Act prohibits in an installment sales contract covering the purchase of a car any provision relieving the assignee from any legal remedy the buyer may have under the contract, but the relevant subsection ends with this sentence: "[T]his subsection shall in no way impair or affect the rights and powers of a holder in due course of a negotiable instrument."<sup>168</sup> On the other hand, there is no provision in the Act for validating a waiver clause by notice as there is in the Retail Installment Sales Act. Consequently (and this is not uncommon), as between "goods" and "motor vehicles," there are substantial differences in approach within the same jurisdiction. Michigan also regulates a certain type of service contract by means of a Home Improvement Finance Act.<sup>169</sup> The intent of its drafters was to interdict questionable activities of siding salesmen. This legislation provides that the contract regulated cannot require the execution of a negotiable promissory note,<sup>170</sup> but it does give effect to waivers of defenses if the buyer does not respond to proper notice.<sup>171</sup>

So it is that in Michigan waivers may be valid in contracts for the sale of goods and for home improvements if notice is given, but such clauses are specifically barred in motor vehicle contracts. The attempt for home-improvement transactions is to eliminate negotiability that is explicitly encouraged in contracts for the sale of motor vehicles. The

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(f) The buyer agrees not to assert against the seller or against an assignee a claim or defense arising out of the sale.

A retail installment contract is an instrument reflecting a retail installment transaction, *id.* § 19.416(102)(g), which in turn is any transactions in which a retail purchases *goods* or services from a retail seller pursuant to a credit arrangement, *id.* § 19.416(102)(f). "Goods" means all tangible chattels personal when purchased primarily for personal, family, or household use and not for commercial or business use. *Id.* § 19.416(102)(a). Nearly all key terms are elaborately defined and carefully interwoven into the statutory web.

<sup>165</sup> *Id.* § 19.416(102)(a).

<sup>166</sup> Hawaii has such a statute: HAWAII REV. LAWS §§ 476-1 to -38 (1968).

<sup>167</sup> MICH. STAT. ANN. §§ 23.628(1)-(38) (1957, Supp. 1969).

<sup>168</sup> *Id.* § 23.628(14)(f) (1957).

<sup>169</sup> *Id.* §§ 19.417(101)-(431) (Supp. 1969).

<sup>170</sup> *Id.* § 19.417(207) (Supp. 1969).

<sup>171</sup> *Id.* § 19.417(208) (Supp. 1969).

concept of negotiability is simply ignored in legislation regulating contracts for the sale of goods and services. This pattern of different treatment of the concepts of negotiability and waiver in different circumstances is not at all unusual and calls attention to the fact that the UCCC does attempt to deal in a rational way with both concepts and their relationship to all consumer transactions.

We cannot leave the survey of legislative response without considering briefly the ensuing judicial reaction. A recent California Supreme Court decision supplies in a nutshell what the response of the courts ought to be:

The Unruh Act represents a constructive effort by the Legislature to protect consumers in the State of California in the all-important area of installment contracts. In interpreting the act we must seek the achievement of the legislative purpose of according to consumers who are parties to such contracts the full protection of the salutary statute. We must particularly avoid the emasculation of section 1812.7<sup>172</sup> by a too ready acceptance of the excuse of the finance company that it lacked the "knowledge" required by that section.<sup>173</sup>

Incidentally, one of the salutary features of the California statute authorizes the awarding of attorney's fees to the party prevailing on the contract, and the court held that the prevailing consumer was entitled to such fees.<sup>174</sup> This provision, which is also a feature of the UCCC,<sup>175</sup> may well be one of the strongest strings for the bow of the consumer. When word penetrates the sanctums of finance companies that violations of such regulatory acts mean not only loss of the profit on the loan, but an actual subtraction of the amount of attorney's fees awarded the consumer as well, the financiers will have an added incentive to see to it that the dealers with whom they do business do not create defenses.

#### CLASSIFICATION PROBLEMS

In *Morgan v. Reasor Corp.*,<sup>176</sup> the California Supreme Court faced a typical problem of statutory classification: did the California Unruh

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<sup>172</sup> CAL. CIV. CODE § 1812.7 (West Supp. 1970) denies to finance companies the time-price cash-price differential—the profit—in transactions that violate the act (footnote added).

<sup>173</sup> *Morgan v. Reasor Corp.*, 69 Cal. 2d 881, 897-98, 447 P.2d 638, 649, 73 Cal. Rptr. 398, 409 (1968).

<sup>174</sup> *Id.* at 896, 447 P.2d at 648-49, 73 Cal. Rptr. at 408-09.

<sup>175</sup> UNIFORM CONSUMER CREDIT CODE § 5.202(8).

<sup>176</sup> 69 Cal. 2d 881, 447 P.2d 638, 73 Cal. Rptr. 398 (1968).

Act,<sup>177</sup> which regulates the installment sale of goods, apply to the purchase of components of a prefabricated house to be erected on land? Applying an intelligent, albeit a technical and intricate, reading of the appropriate definitional sections and keeping in mind the consumer-oriented view of the enactment, the court had little trouble deciding that the Act did regulate such a sale.

The judicial process by which a court decides whether a particular statute's classification system applies to the fact situation before it is a common one. When an aluminum siding company rents a small coffee vending machine for its office, the transaction is not within New York's consumer legislation.<sup>178</sup> When the transaction takes the form of a direct loan, "obviously" no installment sale is involved; therefore, the bank (although the named payee) is clearly a holder in due course of a negotiable promissory note issued in connection with an allegedly fraudulent home-freezer plan.<sup>179</sup> When the basic transaction is classified as a lease and the participants are businessmen, a similar result follows.<sup>180</sup> A tractor bought by a farmer is clearly not a consumer good within the meaning of section 9-206 of the Uniform Commercial Code.<sup>181</sup> Aluminum siding to be installed on one's home is not covered by a statute prohibiting negotiable notes in sales of consumer goods.<sup>182</sup>

Classification decisions reflect the statutory definitional systems in those jurisdictions that have enacted consumer legislation. The focus of the statute may be on a retail installment sale requiring at least one or more installments,<sup>183</sup> on the door-to-door transaction,<sup>184</sup> or, most typically, on the sale of consumer goods, the definition of which usually excludes goods sold for agricultural or business purposes.<sup>185</sup> In *Morgan*, the California court's interpretation of the statutory definitions of "goods" and

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<sup>177</sup> CAL. CIV. CODE §§ 1801-1812.10 (West Supp. 1970).

<sup>178</sup> *Fairfield Lease Corp. v. Colonial Aluminum Sales, Inc.*, 3 U.C.C. Rep. Serv. 858 (N.Y. Sup. Ct. 1966).

<sup>179</sup> *Waterbury Sav. Bank v. Jaroszewski*, 238 A.2d 446 (Conn. Cir. Ct. 1967); Littlefield, *Preserving Consumer Defenses: Plugging the Loophole in the New U.C.C.C.*, 44 N.Y.U.L. Rev. 272 (1969).

<sup>180</sup> *Transamerica Leasing Corp. v. Van's Realty Co.*, 91 Idaho 510, 427 P.2d 284 (1967).

<sup>181</sup> *Beam v. John Deere Co.*, 240 Ark. 107, 398 S.W.2d 218 (1966).

<sup>182</sup> *Universal C.I.T. Credit Corp. v. Ingel*, 347 Mass. 119, 196 N.E.2d 847 (1964).

<sup>183</sup> MICH. COMP. LAWS § 445.852(f) (1948); 2 C.C.H. CONSUMER CREDIT GUIDE ¶ 6102(f).

<sup>184</sup> See Door-to-Door Retail Installment Sales Act of 1968, N.J. REV. STAT. §§ 17:16c-61.1 to 17:16c-61.9 (Supp. 1969).

<sup>185</sup> See UNIFORM COMMERCIAL CODE §§ 9-206, 9-109(1) (1962 version).

"services" resulted in the conclusion that the sale of a prefabricated house was covered.<sup>186</sup> (During the 1969 session of the California Legislature, the Unruh Act was amended to exclude such a transaction.)<sup>187</sup>

The Uniform Consumer Credit Code provisions are particularly illustrative of a complex classification scheme, and are certain to create continuing problems for the consumer's lawyer. In considering this complexity, it should be realized that the UCCC has rejected the narrow and piecemeal legislative approach that historical development had produced in several states.<sup>188</sup> The UCCC was intended to cover all phases of consumer transactions—installment sales, consumer credit loans, usury, regulation, and disclosure. The pervading concept is that the consumer credit transaction is a single subject despite its many facets. The sections of the UCCC with which we are particularly concerned (because they are intended to permit defenses by consumers against transferees) are those that prohibit negotiable instruments "other than a check" in a "consumer credit sale or a consumer lease other than a sale or lease primarily for agricultural purposes"<sup>189</sup> and subject an assignee to defenses despite a waiver clause<sup>190</sup> in the same type of transaction. The key phrases are

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<sup>186</sup> 69 Cal. 2d at 887-89, 447 P.2d at 642-43, 73 Cal. Rptr. at 402-03.

<sup>187</sup> CAL. CIV. CODE § 1801.4 (West Supp. 1970).

<sup>188</sup> See LEGISLATIVE RESPONSE p. 531 *supra*.

<sup>189</sup> UNIFORM CONSUMER CREDIT CODE § 2.403 (1968 Final Draft).

<sup>190</sup> The UNIFORM CONSUMER CREDIT CODE § 2.404 in pertinent part states:  
*Alternative A:*

[Assignee Subject to Defenses]

With respect to consumer credit sale or consumer lease, other than a sale or lease primarily for an agricultural purpose, an assignee of the rights of the seller or lessor is subject to all claims and defenses of the buyer or lessee against the seller or lessor arising out of the sale or lease notwithstanding an agreement to the contrary, but the assignee's liability under this section may not exceed the amount owing to the assignee at the time the claim or defense is asserted against the assignee. Rights of the buyer or lessee under this section can only be asserted as a matter of defense to or set-off against a claim by the assignee.

*Alternative B:*

[When Assignee Not Subject to Defenses]

(1) With respect to a consumer credit sale or consumer lease, other than a sale or lease primarily for an agricultural purpose, an agreement by the buyer or lessee not to assert against an assignee a claim or defense arising out of the sale or lease is enforceable only by an assignee not related to the seller or lessor who acquires the buyer's or lessee's contract in good faith and for value, who gives the buyer or lessee notice of the assignment as provided in this section and who, within 3 months after mailing of the notice of assignment, receives no written notice of the facts giving rise to the buyer's or lessee's claim or defense. . . .

"consumer credit sale" and "primarily for agricultural purposes." The UCCC defines a consumer credit sale as a sale of goods on credit in which "the goods . . . are purchases primarily for a personal, family, household or agricultural purpose . . . ."<sup>191</sup>

The alert reader has already spotted a major classification problem. Why include agricultural goods within the definition of a consumer credit sale and exclude them from the negotiability and waiver sections? Of course, from the standpoint of drafting, the answer is relatively simple. A decision was reached to subject agricultural transactions to regulations concerning disclosure, maximum charges, and other matters treated elsewhere in the UCCC, but to exclude such transactions from limitations on negotiability and waiver. The substantive inquiry—why?—is difficult to answer. Apparently the treatment of agricultural transactions represents a compromise, a partial yielding to the view that farming is really a business and that when a farmer purchases goods for his farm, he is a businessman and thus free to contract as he wishes. Much the same view may be seen in those decisions in which waivers are upheld, at least partially, because the obligor is a small businessman and not a consumer.

The foregoing remarks are meant to be illustrative and are not an attempt to explore such mechanics exhaustively. For our purposes the point is that classification will continue to be a sizeable problem for the consumer's lawyer even though statutory protection has been extended.

If protection is extended to an obligor by judicial decree rather than by statute, the bounds of the protection are more amorphous and perhaps for that reason more workable. The statements of the "inextricably-interwoven" rule<sup>192</sup> and those opinions that hold waivers of defense void as against public policy are invariably phrased in terms of consumer

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(2) An assignee does not acquire a buyer's or lessee's contract in good faith within the meaning of subsection (1) if the assignee has knowledge or, from his course of dealing with the seller or lessor or his records, notice of substantial complaints by other buyers or lessees of the seller's or lessor's failure or refusal to perform his contracts with them and of the seller's or lessor's failure to remedy his defaults within a reasonable time after the assignee notifies him of the complaints.

(3) To the extent that under this section an assignee is subject to claims or defenses of the buyer or lessee against the seller or lessor, the assignee's liability under this section may not exceed the amount owing to the assignee at the time the claim or defense is asserted against the assignee and rights of the buyer or lessee under this section can only be asserted as a matter of defense to or set-off against a claim by the assignee.

<sup>191</sup> UNIFORM CONSUMER CREDIT CODE § 2.104(1)(c) (1968 Final Draft).

<sup>192</sup> See pp. 511-12 *supra*.

protection; sometimes they are also couched in terms of unconscionability and of contracts of adhesion.<sup>193</sup>

Ordinarily, statutes oriented toward protecting the consumer specifically exclude business transactions; the difficulty is to incorporate the protection extended by these laws to the many situations that fall just short of a placid reading of the statutory line, that is, situations in which the obligor cannot easily be described in consumer terms. For example, one of the more recent decisions upholding the validity of a waiver clause is *General Electric Credit Corp. v. Tidenberg*.<sup>194</sup> Tidenberg was apparently a small businessman; he purchased some dry-cleaning units and some dryers from a dealer and signed the usual documents, one of which was a conditional sales contract containing a waiver clause, that the seller eventually assigned to the plaintiff. The case represents a pristine example of the use of summary judgment by a plaintiff-financing agency in these situations. Introducing the deposition of the defendant and an affidavit of its own credit manager to the effect that it had acquired the paper without notice of any claim and for a substantial sum of money, the financing agency moved for summary judgment, which was granted. The only argument the defendant had on appeal was that the waiver clause was void as against public policy, and, therefore, his counterclaim for breach of warranty ought to have been heard. But since section 9-206 of the UCC<sup>195</sup> could not be relied on by the defendant because dry-cleaning units are not consumer goods, the plaintiff was successful.

The statutory trend has been to classify business, commercial, and agricultural transactions as outside the ambit of consumer protection, but case law has many times extended to such transactions the benefit of the developing rules that were originally asserted on behalf of a defendant-consumer. For example, two of the leading cases holding that a finance company may be so closely related to the dealer that the installment purchaser may assert defenses against the financier (even though traditionally he might well have been a holder in due course of a negotiable promissory note) have involved fact situations in which the obligor was clearly purchasing equipment for his business.<sup>196</sup> Yet the earliest case in the field, *Commercial Credit Co. v. Childs*,<sup>197</sup> and most of the decisions invalidating

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<sup>193</sup> Littlefield, *supra* note 179 at 278.

<sup>194</sup> 78 N.M. 59, 428 P.2d 33 (1967).

<sup>195</sup> See note 137 *supra*.

<sup>196</sup> *Commercial Credit Corp. v. Orange County Mach. Works*, 34 Cal. 2d 766, 214 P.2d 819 (1950); *Mutual Fin. Co. v. Martin*, 63 So. 2d 649 (Fla. 1953).

<sup>197</sup> 199 Ark. 1073, 137 S.W.2d 260 (1940).

waivers have done so in the name of consumer protection.<sup>198</sup> One way to reconcile the cases is to assert that, in fact, the "inextricably-interwoven" doctrine will be available to anyone who can show the necessary constellation of facts to permit application of the rule even though he is not a consumer.

In *Massey-Ferguson, Inc. v. Utey*,<sup>199</sup> the Kentucky Court of Appeals, in the face of a waiver clause and prior decisions supporting waivers, reached a result favorable to a purchaser of a two-row, corn-head combine attachment. The court applied the "inextricably-interwoven" doctrine and classified the manufacturer as the real seller of the goods and, therefore, subject to the defenses. A similar result was reached by a trial court in New York—a jurisdiction where there is, in fact, specific legislation dealing with waiver clauses.<sup>200</sup> Again, the court utilized the "inextricably-interwoven" doctrine as the basic premise in denying a finance company's motion for summary judgment. In some ways the case is ironic: the obligor advocating the right to assert defenses was an aluminum siding company that had leased a coffee vending machine for its office.

Several patterns are possible in combining statutes and case precedent. The most common statutory element in the combination will be section 9-206 of the UCC and legislation prohibiting the extraction of negotiable promissory notes and either prohibiting or limiting the use of waivers in consumer transactions.<sup>201</sup> As emphasized elsewhere,<sup>202</sup> section 9-206 incorporates the good-faith rule and permits the utilization of case precedent as a device for protecting the obligor even in non-consumer transactions. Of course, section 9-206 itself raises classification issues since it permits the enforceability of waivers even in transactions involving consumer goods unless they are otherwise treated by an independent rule of law and defines consumer goods in a manner excluding business and agricultural transactions.

Judicial precedent illustrates the difficulties that lawyers will face in dealing with section 9-206. Suppose a jurisdiction prior to the Code's adoption had decided that waiver clauses were void as against public policy. Does adoption of section 9-206 indicate a legislative intent to

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<sup>198</sup> Two examples are *Mutual Fin. Co. v. Martin*, 63 So. 2d 649 (Fla. 1953); *Quality Fin. Co. v. Hurley*, 337 Mass. 150, 148 N.E.2d (1958).

<sup>199</sup> 439 S.W.2d 57 (Ky. Ct. App. 1969).

<sup>200</sup> *Fairfield Lease Corp. v. Colonial Aluminum Sales, Inc.*, 3 U.C.C. Rep. Serv. 858 (N.Y. Sup. Ct. 1966).

<sup>201</sup> See LEGISLATIVE RESPONSE p. 531 *supra*.

<sup>202</sup> See GOOD FAITH ASSIGNEE p. 509 *supra*.



overrule the earlier judicial decision? The trial judge in *Noblett v. General Electric Credit Corp.*<sup>203</sup> thought that it did, but the trial judge in *General Electric Credit Corp. v. Beyerlein*<sup>204</sup> disagreed. The Tenth Circuit disagreed also, and reversed the lower court's decision in *Noblett*.<sup>205</sup> In both cases, the trial judges were attempting to construe section 9-206 in light of the holding in *Quality Finance Co. v. Hurley*,<sup>206</sup> a decision invalidating waivers that was handed down before the state adopted the UCC. An Illinois appellate court has concluded that the language of section 9-206 is "an expression of will not of judgment."<sup>207</sup> The court upheld a waiver clause in a consumer transaction by reasoning that the section does not make waivers invalid in consumer cases; it merely permits the result. Since prior law in Illinois had supported waivers, the clause was given effect.<sup>208</sup> In the New Mexico case of *General Electric Credit Corp. v. Tidenberg*,<sup>209</sup> a finance company argued successfully that legislative adoption of section 9-206 amounted to explicit approval of a waiver clause since there had been no prior decision concerning the question.<sup>210</sup>

There is at the base of all these controversies a fundamental classification issue: is the transaction a sale or a loan? There is no overwhelming reason that requires a finance company to use the historical method of financing—the one whereby the seller has the buyer execute a contract and promissory note in which the seller is the named payee and that the seller then transfers by assignment and negotiation to the financing company. If restrictions on that method become too burdensome, presumably all the finance company need do is instruct the dealer to send the buyer to its office to obtain a loan. If the finance company simply loans a consumer a sum of money, what the borrower then does with it is irrelevant, at least from the traditional legal viewpoint. There is evidence that finance companies are beginning to utilize this approach to avoid the problem of consumer defenses. The probability appears so cogent that a proposed (but unofficial) amendment to the Uniform Consumer

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<sup>203</sup> 268 F. Supp. 984 (W.D. Okla. 1967), *rev'd*, 400 F.2d 442 (10th Cir. 1968).

<sup>204</sup> 55 Misc. 2d 724, 286 N.Y.S.2d 351 (Sup. Ct. 1967), *rev'd*, 30 App. Div. 762, 292 N.Y.S.2d 33 (1968).

<sup>205</sup> *Noblett v. General Elec. Credit Corp.*, 400 F.2d 442 (10th Cir. 1968).

<sup>206</sup> 337 Mass. 150, 148 N.E.2d 385 (1958).

<sup>207</sup> *First Nat'l Bank v. Husted*, 57 Ill. App. 2d 227, 233, 205 N.E.2d 780 (1965). The legislature in Illinois thereafter validated waivers in consumer situations by enacting a notice-waiver statute. ILL. ANN. STAT. ch. 121½, § 517 (Smith-Hurd Supp. 1969).

<sup>208</sup> 57 Ill. App. 2d at 233, 205 N.E.2d at 783.

<sup>209</sup> 78 N.M. 59, 428 P.2d 33 (1967).

<sup>210</sup> *Id.* at 62, 428 P.2d at 36.

Credit Code has been drafted to encompass loan transactions made "in close connection" with sales to consumers.<sup>211</sup>

In *Waterbury Savings Bank v. Jaroszewski*,<sup>212</sup> the loan pigeonhole enabled the financing agency to cut off a defense of the consumer, who was another victim of a food-freezer plan. The Jaroszewskis filled out a four-page printed form that prominently displayed the name of the financing bank. The first page was captioned "Request for Personal Loan," the second page was a negotiable promissory note, the third page a credit application, and the fourth an authorization by the consumer directing the bank to pay the proceeds of the loan to the seller. The salesman of the corporation had given the buyers the four-page form, along with the ordinary contract, and they had signed both instruments. The bank was successful on its suit brought on the promissory note. Since it was payee on the note, since a payee may be a holder in due course, and since the bank had no actual knowledge of the alleged fraud, the court held that the bank was obviously a holder in due course in this situation.<sup>213</sup> The bank had financed five or six hundred transactions for the freezer company and had received only three or four prior complaints! The result may not have been otherwise had the note been payable to the dealer, but the impression is strong that the form of the transaction influenced the judge.

#### NORTH CAROLINA LAW

The Uniform Commercial Code has been in effect in North Carolina since July 1, 1967. As we have seen, the Code continues the principle of negotiability by form in Article 3. It continues the subjective test of good faith of the holder in due course by its definition of good faith in terms of honesty in fact.<sup>214</sup> The unconscionability doctrine of section 2-203 was not included in the North Carolina version of the Code. Section 9-206 validates waiver clauses in North Carolina, subject to other statutes and decisions with respect to consumer goods.<sup>215</sup> There are, however, no statutes that give the consumer who buys on credit the kind of protection contemplated by the Uniform Consumer Credit Code. What statutes there are concern such matters as usury, the regulation of

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<sup>211</sup> Littlefield, *supra* note 179 at 293.

<sup>212</sup> 238 A.2d 446 (Conn. Cir. Ct. 1967).

<sup>213</sup> *Id.* at 448.

<sup>214</sup> N.C. GEN. STAT. § 25-1-201(19) (1965).

<sup>215</sup> N.C. GEN. STAT. § 25-9-206 (1965).

direct loans, and interest rates.<sup>216</sup> Judicially, North Carolina has been one of the jurisdictions that has rigidly adhered to the time-price, cash-price doctrine and its courts cannot be said to be consumer-oriented.<sup>217</sup> No North Carolina decision directly adjudicating the validity of waiver-of-defense clauses has been found.

*B-W Acceptance Corporation v. Spencer*<sup>218</sup> was an action on a negotiable note given by the defendant for the purchase of coin-operated laundry machinery from Southeast Machinery Corporation, alleged to be an agent of the manufacturer. The defendant pleaded a counterclaim against the plaintiff and third-party claims against Southeast, Norge Sales Corporation (the manufacturer), and Borg-Warner Corporation. Both Norge and the plaintiff were wholly owned subsidiaries of Borg-Warner. The counterclaim and crossclaims were grounded on allegations of fraud and breach of warranty. The plaintiff's action was begun less than three years after the defendant's discovery of the fraud and breach, but the third-party claims were filed more than three years thereafter. The court, conceding that the commencement of the action tolled the statute of limitations as to a transaction-clause counterclaim against the plaintiff, sustained the plea of the statute by the third-party defendants. The parent-subsidiary relationship was not considered sufficient to show that Borg-Warner exercised such control as to justify disregarding the separate corporate entities. Judgment on the pleadings was then given for the plaintiff. The court found no allegations justifying a conclusion that the plaintiff would be responsible for any fraud or breach by the third-party defendants. If a waiver clause was in fact involved, it was not discussed by the court. The status of the plaintiff as a holder in due course was not judicially questioned though the facts might well have been regarded as calling for an application of the objective test of good faith.

There is one decision that may permit the application of the doctrine of objective good faith to subsequent North Carolina litigation involving the range of controversies that we have been examining. The case is *Whitfield v. Carolina Housing & Mortgage Corp.*<sup>219</sup> Late at night, talking with a man who was traveling through the country repairing houses and who wanted to work on his, Chadbourn Whitfield signed a contract for the repair of his home. At the same time the salesman handed him

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<sup>216</sup> See generally Comment, *Usury Law in North Carolina*, 47 N.C.L. REV. 761 (1969).

<sup>217</sup> *Id.* 777-78.

<sup>218</sup> 268 N.C. 1, 149 S.E.2d 570 (1966).

<sup>219</sup> 243 N.C. 658, 92 S.E.2d 78 (1956).

the contract, he also handed him two folded pieces of paper exposing only signature lines and asked him to sign them. Whitfield inquired if they were mortgages since he did not want to mortgage his property and "he couldn't read fine print." The salesman told him they were not mortgages and again requested that he sign. They were, of course, a negotiable promissory note and a deed of trust on Whitfield's land. They turned up in the hands of Carolina Housing & Mortgage Corporation, an alleged holder in due course, and eventually Mr. Whitfield brought suit seeking their cancellation.

As in the Ohio case of *American Plan Corp. v. Woods*,<sup>220</sup> the North Carolina court commendably did not inquire too closely into the question of Whitfield's negligence in signing. The trial court had proceeded on the theory that the nature of the fraud was the kind that rose only to a personal defense, locally known as fraud in the treaty, although the facts strongly suggest that the real defense of fraud in the factum would not have been an improper classification. The supreme court accepted the trial court's assumption and then considered whether the financing agency had carried its burden of proof on the issue of good faith;<sup>221</sup> a defense good against the seller had been established, and this result shifted the burden to the holder. Rejecting the argument of the financing agency that there was no evidence of its bad faith, the court, deciding for the consumer, said:

The note and deed of trust here were filled out on the forms of the Carolina Housing & Mortgage Corporation. The note was payable to the order of Consolidated Roofing Company at the office of Carolina Housing & Mortgage Corporation. The trustee named in the deed of trust was a principal officer of Carolina Housing & Mortgage Corporation. The date of the assignment without recourse of the note by the payee does not appear . . . When all the facts attendant upon the transaction are considered, it cannot be successfully contended, in our opinion, that no fair or reasonable inference is permissible from the evidence that the Carolina Housing & Mortgage Corporation is not a holder in due course for value and without notice of the infirmity of the note.<sup>222</sup>

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<sup>220</sup> 16 Ohio App. 2d 1, 240 N.E.2d 886 (1968). This case is discussed also at p. 528 *supra*.

<sup>221</sup> This is another example of a court using an "old" rule to achieve a proper result. See N.C. GEN. STAT. § 25-3-307(3) (1965) for the current statement of the burden of proof rule.

<sup>222</sup> 243 N.C. at 662-63, 92 S.E.2d at 81.

With section 9-206 now in effect, the continuing problems that this article has reviewed face North Carolina attorneys. The definition of consumer goods as it appears in the Code,<sup>223</sup> for example, excludes services; it could be argued that technically a fact situation similar to the one in *Whitfield*, but involving waiver and not holder-in-due-course status, would be outside the ambit of the "subject to" clause of section 9-206, and thus the waiver would be enforceable. On the other hand, if the standard of objective good faith of the assignee is adopted, the utilization of objective facts, as in *Whitfield*, is clearly permitted. Obviously, the court should adopt such an objective standard.

Over the years various consumer-protection bills have been introduced in the North Carolina General Assembly. During the 1969 legislative session, a Retail Installment Sales Act, which would have cut off negotiability in consumer transactions and prohibited waivers of defenses, was introduced, but action on it was postponed indefinitely by the House.<sup>224</sup> That bill excluded motor vehicles from its coverage. A Motor Vehicle Retail Installment Sales Act had appeared earlier.<sup>225</sup> This latter bill, reported unfavorably by the House Committee on Banks and Banking, contained no reference to negotiability or to waiver clauses.

A consumer sued by a financing agency sometimes faces problems of limitations and of third-party practice. In North Carolina, the limitation period on a sealed instrument is ten years,<sup>226</sup> and nearly all negotiable promissory notes bear that magic word, "seal." The ordinary contract action bears a limitation period of three years, and a cause of action sounding in fraud is limited to three years after the discovery of the facts constituting the fraud.<sup>227</sup> Prior to 1969, a buyer who signed a negotiable promissory note as part of a consumer credit transaction could have found himself being sued by the holder when the statute of limitations on any claim he had against the seller had long since run. The buyer also faced questions of third-party practice when he attempted to implead the seller into the holder's suit against him. An enactment by the 1969 General Assembly attempted to deal with these problems.<sup>228</sup> This legislation

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<sup>223</sup> N.C. GEN. STAT. §§ 25-9-109(1), 25-9-105(f) (1965).

<sup>224</sup> Institute of Government Legislative Service, Final Disposition of Bills and Resolutions, H.B. 1129 [1969] N.C. Gen. Assembly.

<sup>225</sup> *Id.* H.B. 757.

<sup>226</sup> N.C. GEN. STAT. § 1-47(2) (1969).

<sup>227</sup> N.C. GEN. STAT. §§ 1-52(1), (9) (1969).

<sup>228</sup> The following language was added to N.C. GEN. STAT. § 1-47(2) (1969):

Provided, however, that if action on a sealed instrument is filed, the defendant or defendants in such action may file a counterclaim arising out

amended the statute-of-limitations section concerning sealed instruments to provide that the maker of a sealed instrument can assert any claim arising out of the transaction against either the plaintiff or against a third party even though a shorter statute of limitations would otherwise bar such a claim.<sup>229</sup> The same Act also permits the court, upon motion by the defendant-maker, to include in the holder's action such parties as the assignor or transferor of the plaintiff.<sup>230</sup> The Act then states that the purpose underlying it is "to insure that if a suit may be maintained on a contract against one contracting party, the other contracting party will not be allowed to escape his contractual obligations by the passage of time or the transfer of contract rights."<sup>231</sup>

Note that all the legislation purports to do substantively is to extend the statute of limitations with respect to the claim of the defendant. If the note upon which suit is brought is negotiable, the maker cannot assert his personal defenses against a holder in due course, at least as matters now stand. The new legislation does not touch this situation, for it is not the statute of limitations that bars a maker from asserting his defenses against a holder in due course—it is the principle of negotiability. If the seller-assignor-transferor is bankrupt or without the jurisdiction or judgment proof, the new act is of no assistance. In *Acceptance Corporation* the seller was apparently bankrupt, and even if the new act had been available to permit a third-party claim against it, the maker still would have had to pay.

As to third-party practice, the Act seems to make explicit the state of the law prior to its enactment. That is, the matter of impleading such

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of the same transaction or transactions as are the subject of plaintiff's claim, although a shorter statute of limitations would otherwise apply to defendant's counterclaim. Such counterclaim may be filed against such parties as provided in G.S. Sec. 1A-1, Rules of Civil Procedure.

The act also added a new paragraph to N.C.R. Civ. P. 14(a), N.C. GEN. STAT. § 1A-1 (1969):

Where the normal statute of limitations period in an action arising on a contract is extended as provided in G.S. Sec. 1-47(2) or in any action arising on a contract or promissory note, upon motion of the defendant the court may order to be made parties additional defendants, including any party of whom the plaintiff is a subrogee, assignee, third party beneficiary, endorsee, agent or transferee, or such other person as has received the benefit of the contract by transfer of interest.

Both changes were effective January 1, 1970, and apply to actions pending on that date as well as to those commenced after that date.

<sup>229</sup> N.C. GEN. STAT. § 1-47 (1969).

<sup>230</sup> N.C.R. Civ. P. 14(a), N.C. GEN. STAT. § 1A-1 (1969).

<sup>231</sup> Ch. 810, § 2, para. 2 [1969] N.C. Sess. L. —, quoted in Editor's Note to N.C. GEN. STAT. § 1A-1 (1969) (Rule 14).

parties as the maker's payee-seller has been within the discretion of the trial judge.<sup>232</sup> That discretion has been exercised both for and against the maker in a number of cases arising under the statute's parent, Federal Rule of Civil Procedure 14,<sup>233</sup> and this new North Carolina legislation does not appear to alter the discretionary power of the trial judge.

The end sought by legislation such as this—protection of the consumer from nefarious practices arising out of tripartite situations—is naturally worthy of the legislature's attention.<sup>234</sup> A better approach would be to alter the substantive law so that the cutting off of consumer defenses would be invalid. This result could be accomplished in any number of ways. An example can be seen in sections 2.403 and 2.404-A of the Uniform Consumer Credit Code, which invalidate negotiability and waivers in consumer transactions.<sup>235</sup> One consequence of such an enactment would be that the consumer-defendant would at least be able to recoup his losses to the extent of the plaintiff's claim, as is the case currently with respect to ordinary contract assignments.<sup>236</sup>

The General Assembly by joint resolution during the 1969 session established the Uniform Consumer Credit Code Study Commission.<sup>237</sup> This Commission is charged with the responsibility of studying and evaluating the Uniform Consumer Credit Code. The Commission has the duty of submitting a written report to the 1971 session of the General Assembly setting forth its findings, conclusions, and recommendations with respect to the UCCC.

In conclusion, one can only urge those involved with consumers and their contracts to adopt the approach of Mr. Cahn, set forth at the beginning of this article. Any reasoned treatment of the field is obviously superior to the hodgepodge development that history otherwise forces upon us. But even then, the resolution of such disputes as will continue

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<sup>232</sup> *Overton v. Tarkington*, 249 N.C. 340, 106 S.E.2d 717 (1959). *But cf.* *Standard Amusement Co. v. Tarkington*, 247 N.C. 444, 101 S.E.2d 398 (1958).

<sup>233</sup> *E.g.*, *United States v. Scott*, 18 F.R.D. 324 (S.D.N.Y. 1955) (seller admitted for limited purpose); *United States v. De Haven*, 13 F.R.D. 435 (W.D. Mich. 1953) (seller not admitted); *United States v. Pryor*, 2 F.R.D. 382 (N.D. Ill. 1940) (seller admitted).

<sup>234</sup> In a telephone interview on January 19, 1970, the sponsor of the legislation, Rep. Robert A. Jones of Forest City, N. C., described the typical aluminum-siding fraud as the type of conduct the legislation in question was designed to interdict.

<sup>235</sup> See p. 533 *supra* for a full discussion of these sections.

<sup>236</sup> See N.C. GEN. STAT. § 1-57 (1969); *Overton v. Tarkington*, 249 N.C. 340, 106 S.E.2d 717 (1959).

<sup>237</sup> H.R.J. Res. 101, [1969] N.C. Gen. Assembly.

to exist between buyers, sellers, and lenders needs the application of a guiding principle such as that advocated by Mr. Cahn, if only because we cannot foresee the unforeseeable. By way of example and puzzlement, examine your bank credit card. If yours is issued by one of the large organizations in this expanding (and until recently unforeseeable) field, the last sentence of the contractual provisos on its reverse side reads as follows:

The person who signs, uses or authorizes use of this card agrees to be bound by issuer's charge-card agreement and rules as in effect from time to time, including . . . (2) waiver as to issuer of defenses and claims against other persons.

How about that?